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Changes in the taxation of Trusts

Denis Barlin
Michael Bennett

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Changes in the Taxation of Trusts

A paper presented by Michael Bennett and Denis Barlin at the NSW Young Lawyers CLE

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Michael Bennett E bennett@sevenwentworth.com.au D 8224 3055 M 0408 029 416
Denis Barlin E dbarlin@wenworthchambers.com.au D 9231 6646 M 0404 848 311

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1. General overview

1.1 The income years ended 30 June 2010 and, more particularly, 30 June 2011 have been very active for the taxation of trusts. Significant events in three areas of trust taxplay activity:

1.1.1 decisions of the Courts and principally the High Court's decision in *Commissioner of Taxation v Bamford* (2010) 240 CLR 481; (2010) 264 ALR 436; [2010] HCA 10 ("**Bamford**");

1.1.2 legislative changes, principally:

1.1.2.1 the new rules set out in *Tax Laws Amendment (2011 Measures No. 5) Act* 2011 (Cth) (the "**Streaming Amendments**") that deal with taxation of franking credits and capital gains in trusts; and

1.1.2.2 the new rules set out in the *Tax Laws Amendment (2010 Measures No. 2) Act* 2010 (Cth) that are principally about Division 7A of Part III of the *Income Tax Assessment Act* 1936 (Cth) (the "**1936 Act**") and companies providing rights to use property, but also contain some trust issues (the "**Div 7A Amendments**"); and

1.1.3 Australian Taxation Office ("**ATO**") activities principally the very controversial draft ruling on unpaid present entitlements, TR 2009/D8.

1.2 Some of these changes have overtaken themselves. For instance, there was at the time – and this paper includes – a discussion of streaming post Bamford (see **heading 4** below). That discussion should be read as having been overtaken by the Streaming Amendments (see **heading 5**).

1.3 And what's more the change is not over. Chapter 2 of the explanatory memorandum to the Bill that introduced the Steaming Amendments makes it clear that the streaming provisions have been introduced as an interim measure to deal with perceived anomalies in the taxation of capital gains and franked distributions pending a comprehensive review of Division 6 of Part II of the 1936 Act.

1.4 The changes made so far give rise to issues themselves and further consequential issues for trusts. In addressing the issues – both outlined above and the consequential issues – this paper will discuss:

1.4.1 Taxation of trusts generally;

1.4.2 The competing views before Bamford;

1.4.3 The context of Bamford and what it means for trusts;

1.4.4 Briefly (as it is not germane to the other issues raised in the paper) what are the Div 7A Amendments and what they mean for trusts;

1.4.5 What are the Steaming Amendments and what they mean for trust;

1.4.6 What a trust deed needs in light of those three issues; and

1.4.7 Amending trust deeds to deal with those three issues.

1.5 The issues are dealt with in this order as they are chronological to their occurring.

2. Taxation of Trusts

2.1 The provisions dealing with the taxation of trust income are contained in Division 6 of Part III of the 1936 Act (which comprises of sections 95 to 102).

2.2 As a result of the enactment of Streaming Amendments, regard should also be given to:

2.2.1 Subdivision 207-B of the *Income Tax Assessment Act* 1997 (Cth) (the "**1997 Act**") – which deals with franking credits obtained by a trust estate; and

2.2.2 Subdivision 115-C of the 1997 Act – which deals with the distribution of capital gains by a trust estate.

2.3 Chief Justice Latham in *Tindal v FC of T* (1946) 72 CLR 608 at 618 observed that the object of Division 6 of the 1936 Act is to "*… secure payment of tax upon the whole of the net income of a trust estate, either from a beneficiary or the trustee, whether the income is paid over to or on account of the beneficiary …*". Further, according to Emmett J in *Bamford v Federal Commissioner of Taxation* (2009) 176 FCR 250 "*… an important assumption underlying Division 6 …* [is] *… that a beneficiary who derives a share of the net income should be in a position to pay out of that income; otherwise, the beneficiary could be placed in a difficult position*."

2.4 The starting point in determining the taxation of trust income is s 97 of the 1936 Act. Relevantly, s 97(1) of the 1936 Act 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; and

(b) the exempt income of the beneficiary shall include:

(i) so much of the individual interest of the beneficiary in the exempt income of the trust estate as is attributable to a period when the beneficiary was a resident; and

(ii) so much of the individual interest of the beneficiary in the exempt 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;

except to the extent to which the exempt income to which that individual interest relates was taken into account in calculating the net income of the trust estate; and

(c) the non-assessable non-exempt income of the beneficiary shall include:

(i) so much of the individual interest of the beneficiary in the non-assessable non-exempt income of the trust estate as is attributable to a period when the beneficiary was a resident; and

(ii) so much of the individual interest of the beneficiary in the non-assessable non-exempt 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]

2.5 That is, s 97 of the 1936 Act provides that where a beneficiary, who is not under a legal disability is presently entitled to a "*… share of the income of the trust estate …*", the assessable income of:

2.5.1 a resident beneficiary includes the beneficiary's share of the '*… net income of the trust estate …*'; and

2.5.2 a non-resident beneficiary includes so much of the beneficiary's share of the net income of the trust as is attributable to sources in Australia.

2.6 It should be noted that the term "net income of the trust estate" for the purposes of s 97 of the 1936 Act is defined in s 95(1) of the 1936 Act. However, the term "*… the income of the trust estate …*" as contained in s 97 of the 1936 Act is not defined in the 1936 Act.

2.7 Subsection 95(1) of the 1936 Act defines the term 'net income', in relation to a trust estate as:

> ***net income**, 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 Division 393 of the Income Tax Assessment Act 1997 (Farm management deposits) 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.*

2.8 For completeness, it should be noted that:

2.8.1 s 98 of the 1936 Act provides that the trustee is liable to tax on behalf of a beneficiary where the beneficiary is presently entitled to a share of the income of a trust estate, but the beneficiary is under a legal disability;

2.8.2 ss 99 and 99A of the 1936 Act apply to subject the trustee to tax where there is some part of the net income of a trust estate that is not subject to tax under either of ss 97 or 98 of the 1936 Act. The difference as between s 99 and s 99A of the 1936 Act is the rate of tax applicable. Typically, the trustee will be subject to tax under section 99A of the 1936 Act at a penal rate of tax equal to the maximum rate of tax (currently 45%). However, the Commissioner has a discretion to apply s 99 of the 1936 Act in certain circumstances, in which case the trustee will be subject to tax at the normal marginal rates of tax.

3. The two competing views before the decision in Bamford

3.1 There has been, for some time, two competing views in the taxation of trust income – the proportionate view and the quantum view.

Proportionate approach

3.2 *David & Anor v FC of T* 89 ATC 4377 contains an example of the application of the proportionate approach (which according to the High Court's decision in Bamford, is the correct approach).

3.3 The proportionate view looks to the share (or proportion) of trust law income of a trust to which a beneficiary is "presently entitled", and then applies that share or proportion to the net income of a trust estate to calculate how much of the net income is to be included in the beneficiary's assessable income.

3.4 As an example, if a beneficiary is entitled to one half of the trust law income, then the beneficiary must include half of the net income in their assessable income – irrespective of whether it is more or less than the amount of the trust law income to which they are entitled.

(a) Implications if tax law income exceeds trust law income

3.5 Under this approach, a beneficiary who is "presently entitled" to trust law income may be required under s 97(1) of the 1936 Act to include in their assessable income an amount of net income which is greater than the amount of trust law income to which they are entitled, and to which has been paid or distributed to them.

3.6 That is, they may be subject to tax on amounts whish they will not receive, and are not entitled to actually receive.

3.7 This outcome seems to be contrary to the objectives of Division 6 of the 1936 Act as outlined by Emmett J in the Full Court of the Federal Court decision in *Bamford v Federal Commissioner of Taxation* (2009) 176 FCR 250 (discussed above).

(b) Implications if trust law income exceeds tax law income

3.8 However, where the net income of a trust estate for the purposes of s 95(1) of the 1936 Act is less than the trust law income, then a beneficiary who is "presently entitled" pursuant to s 97(1) of the 1936 Act will be required to include in their assessable income an amount which is less than the trust law income to which they will be entitled, and which will be paid to them.

3.9 As a result, an on the assumption that the beneficiaries are "presently entitled" to the whole of the trust law income, with the result that the whole of the "net income" of the

trust estate is included in their assessable income pursuant to s 97(1) of the 1936 Act, there can be no part of the net income to which ss 99 or 99A of the 1936 Act applies.

3.10 There is still a question as to whether, in these circumstances, the beneficiary must include the excess amount (i.e. the amount not included under s 97(1) of the 1936 Act) under some provision of the tax acts (e.g. CGT event E4 as contained in s 104-70 of the 1997 Act).

The quantum approach

3.11 The quantum approach (which is no longer good law) is based on the proposition that a beneficiary can only be presently entitled to such amount(s) of trust income as they actually receive.

3.12 Further, any part of the net income of the trust estate which exceeds the amount to which the beneficiary is presently entitled is not income to which the beneficiary is presently entitled to pursuant to s 97 of the 1936 Act, with the result that the trustee is subject to tax on it under s 99A of the 1936 Act (unless the Commissioner exercises it discretion to cause it to be subject to tax under s 99).

3.13 As with the proportionate approach, where the net income of the trust estate for s 95(1) of the 1936 Act purposes is less than the trust law income, such that the beneficiary receives an amount which is greater than the amount included in their assessable income, the question arises as to how the excess is to be taxed (if at all).

4. Bamford

4.1 Bamford was a much anticipated decision. In the view of some[1] the decision was a missed opportunity to settle an area of the trust law and tax law that has been crying out for correction: *Bamford* at [17] citing Hill J in *Davis v Federal Commissioner of Taxation* (1989) 86 ALR 195 at 230.

Background to Bamford

4.2 Mr and Mrs Bamford were beneficiaries of a discretionary trust known as the Bamford Trust (the "**Trust**"). The trustee of the Trust was P&D Bamford Enterprises Pty Ltd. Mr and Mrs Bamford were also the directors and employees of P&D Bamford Enterprises Pty Ltd.

[1] Slater QC *Taxation Trust Income After* Bamfor'ds *Case*, 26th National TIA Convention, 2-4 March 2011

4.3 During the 2000 income tax year, the Trust made a contribution to an offshore superannuation fund on behalf of Mr and Mrs Bamford. The contribution was sourced from borrowings by the corporate trustee, in its capacity as trustee of the Trust.

4.4 For the purposes of determining the "net income" of the Trust for the 2000 income tax year, the corporate trustee (in its capacity as trustee of the Trust) claimed a deduction for both the contribution made to the offshore superannuation fund, and the interest on the borrowed funds used to make the contribution. The total deduction claimed was $191,701.

4.5 After taking into account of the deductions, the "net income" of the Trust for that year was distributed to specified beneficiaries of the Trust. Included in the distribution were Mr and Mrs Bamford, who both had specified amounts distributed to them.

4.6 Specifically, for that income tax year (i.e. the 2000 income tax year), the trustee of the Trust allocated amounts to certain beneficiaries of the Trust, including a payment of $34,000 each to Mr and Mrs Bamford. However, the trustee of the Trust did not have sufficient funds to pay the full amount of $34,000, and instead paid them $33,872, being what the trustee of the Trust thought was the total remaining trust funds.

4.7 The amount initially distributed by the trustee of the Trust was $187,530.

4.8 In 2005, the Commissioner of Taxation applied the anti-avoidance provisions so as to disallow the deductions of the Trust (for the 2000 income tax year) for the superannuation contribution and the interest. As a result of the denial of the deductions, for the purposes of the 2000 income tax year the Trust's taxable income exceeded its accounting income.

4.9 The decision essentially dealt with two things:

4.9.1 whether the 'proportionate approach' applied in the event that tax law income exceeds accounting / trust income; and

4.9.2 whether the trust deed of the trust could characterise an amount of capital gains as income of the Trust.

Application of the proportionate view

4.10 As a result of the denial of the deduction, the Trust's taxable income increased by $191,000. The Commissioner issued amended income tax assessments to both Mr and Mrs Bamford. Pursuant to the assessments, the Commissioner contended that Mr and Mrs Bamford were liable to tax on the increased 'net income' of the Trust based on the proportionate share of the amount by which the taxable income of the trust exceeded the accounting income.

4.11 Indeed, the Commissioner sought to assess Mr and Mrs Bamford on an extra $34,624, on the basis that that amount represented the 'share' of the additional $191,000 as their share (i.e. 18%) of the previous amount (i.e. $187,530) actually distributed.

4.12 However, the taxpayers argued that they should only be taxed on the difference between the $33,872 which they actually received, and the specific amount of $34,000 which was originally allocated to them (i.e. an amount of $128 each).

4.13 The High Court rejected the taxpayer's argument, and in doing so applied the "proportionate approach".

4.14 The High Court took a two step approach in dealing with this issue:

4.14.1 First – the High Court held that the term "*… income of the trust estate …*" as contained in s 97(1) of the 1936 Act refers to distributable income, being income as determined by the trustee taking into account the terms of the trust (e.g. the trust deed) and appropriate accounting principles.

4.14.2 Secondly – after ascertaining the "share" of the distributable income to which a beneficiary is presently entitled, s 97(1) of the 1936 Act then requires that "*… that share of the net income of the trust estate …*" be ascertained, being the shares of the taxable income and not the distributable income.

4.15 Further, it was held that the inclusion within s 97(1) of the 1936 Act of the defined phrase "*… net income of the trust estate …*" and the undefined term "*… the income of …* [the] *… trust estate …*" indicated that these were intended to have different meanings. As a result, the term "*… the income of …* [the] *… trust estate* " had a different and defined meaning for taxation purposes.

4.16 The Court at [45] held that the analysis of Sundberg J in *Zeta Force Pty Ltd v Commissioner of Taxation* (1998) 84 FCR 70 at 74-75 should be applied:

> *The resolution of the second issue of construction is to be found in the analysis by Sundberg J in* Zeta Force Pty Ltd v Commissioner of Taxation *… . His Honour dealt with the first issue of construction to the same effect as that just explained, saying:*
>
> > *"The words 'income of the trust estate' in the opening part of s 97(1) refer to distributable income, that is to say income ascertained by the trustee according to appropriate accounting principles and the trust instrument. That the words have this meaning is confirmed by the use elsewhere in Div 6 of the contrasting expression 'net income of the trust estate'. The beneficiary's 'share' is his share of the distributable income."*
>
> *Sundberg J then continued:*
>
> > *"Having identified the share of the distributable income to which the beneficiary is presently entitled, s97(1) requires one to ascertain 'that share of the net income of the trust estate'. That share is included in the beneficiary's assessable income. The expression 'net income of the trust estate' in par (a)(i) has the meaning given it by s 95(1) – taxable income as opposed to distributable income. The words 'that share' in par (a)(i) refer*

back to the word 'share' in the expression 'a share of the income of the trust estate', and indicate that the same share is to be applied to an income amount calculated according to a different formula (taxable income as opposed to distributable income). Since the income amount may differ according to which formula is applied, the natural meaning to give to 'share' where it appears for the second time is 'proportion' rather than 'part' or 'portion'. When Parliament wanted to convey the latter meaning, as it did in ss 99 and 99A, it used the word 'part'.

The contrast between the expressions 'share of the income of the trust estate' and 'that share of the net income of the trust estate' shows that the draftsman has sought to relate the concept of present entitlement to distributable income, and not to taxable income, which is, after all, an artificial tax amount. Once the share of the distributable income to which the beneficiary is presently entitled is worked out, the notion of present entitlement has served its purpose, and the beneficiary is to be taxed on that share (or proportion) of the taxable income of the trust estate."

4.17 For the 2000 income year, the "net income" of the Trust included the amount of $191,701 which should not have been claimed as a deduction in the tax return of the Trust. As a result, the High Court held that the assessable income of Mr and Mrs Bamford should include a share of that amount, equivalent to the share they each received of the distributable income.

Whether the trust deed could re-characterise amounts

4.18 The trust deed of the Trust gave the trustee the discretion to determine whether a particular receipt should be treated as income or capital.

4.19 The trustee relied on this power to pass a resolution to distribute the first $60,000 of net income, "*… including …* [the] *…. capital gain …*" to Mr and Mrs Bamford in equal shares.

4.20 The Commissioner argued that the capital gain was not income of the Trust. Further, since there was no income, no beneficiary could be 'presently entitled' to the amount in question, the trustee of the Trust should be assessed at the special rates.

4.21 The High Court held that the term "income" as contained in s 99A of the 1936 Act should be interpreted as income of the trust estate, as understood in trust law.

4.22 As a result, the net capital gain of the Trust became the income of the Trust after the trustee exercised its discretion to characterise the capital gain as income of the Trust.

Outcome for Trust Distributions

4.23 There is no room for doubt that Bamford establishes that:

4.23.1 income of the trust estate identified in s 97(1) of 1936 Act is to be determined according to any directions set out in the Trust Deed;

4.23.2 the share of the net income attributable to a beneficiary is to be determined in the same proportions in which the beneficiary enjoys the present entitlement to the share of the income of the trust.

4.24 In this first regard, the Court made it clear that the general rules regarding apportionment between capital and income of receipts and outgoings was largely based on assumptions which could be displaced by the terms of the trust instrument: Bamford at [17]. The general law of trusts operates to give meaning to the term "the income of the trust estate".

4.25 The determination of present entitlement to a share of the income is a process of trust administration. The decision of the Full Court of the Federal Court in *C of T v Totledge Pty Ltd* (1982) 40 ALR 385 at 393 is quoted in support: Bamford at [39]. The High Court distinguished its own decision in *C of T v Australia and New Zealand Savings Bank Ltd* (1998) HCA 53 (Bamford at [39]) as not relevantly addressing the issue. Finally, the Court observed that the Commissioner's lack of consistency in wishing to exclude "statutory income" from "income of the trust estate" did not assist his argument that "income" means "income according to ordinary concepts": Bamford at [41].

4.26 On the meaning of the term "share of the net income" the High Court adopted the proportionate approach advocated by Sunberg J in *Zeta Force* (discussed above).

4.27 What does this translate into for trustees making decisions in respect of trust distributions for the 2010 income year?

4.28 There are a number of relevant observations to be made.

4.29 First, if the Trust Deed provides a formula for determining the income of the trust then that formula will determine the entitlement of the beneficiaries to income. If, for example, the Deed contains words to the following effect:

> *"The net income of the trust is an amount equal to the amount determined in accordance with subsection 95(1) of the* Income Tax Assessment Act 1936 *but reduced by any amount which would otherwise be included by application of Division 207 of the* Income Tax Assessment Act 1997*".*

4.30 Throughout this paper "subsection 95(1) terms" means an amount adjusted for the franking credit gross up. The issue of grossing up is considered below in the context of using the full tax exemption including the franking rebate available to children.

4.31 Leaving aside the elimination of any gross up for franking credits (which itself is affected by the Streaming Amendments as discussed below) the amount of net income for trust law purposes

will equal the tax law income. The two will coincide so that there should, in the ordinary course, be no amount assessable to the trustee under s 99A of the 1936 Act.

4.32 Secondly, if the Trust Deed is silent then "ordinary income" principles apply. Just what they are is difficult to say. The ATO has expressed the view that income of a trust is income according to ordinary principles. This is not the same thing as accounting income determined in accordance with accounting principles. It requires a dissection of receipts into:

4.32.1 income according to ordinary principles;

4.32.2 income which is not ordinary income;

4.32.3 capital receipts.

4.33 Following that dissection, the expenses must be apportioned accordingly.

4.34 This is, of course, all too much. Many trust deeds will have a clause like that in Bamford which allows the trustee to determine whether a receipt is capital or income. Others will have very broad powers allowing the trustee to determine the basis on which income of the trust is to be worked out.

4.35 If these powers exist they should be used to avoid uncertainty brought about by the "ordinary income" approach. If they do not exist then the deed should be to give the trustee such a power. Whether such an amendment will amount to a resettlement, which might have adverse capital gains tax (and stamp duty) consequences, is discussed at **paragraphs xx** below.

4.36 Thirdly, because the proportionate approach has prevailed, a strict application of that rule will mean that great care needs to be taken when seeking to direct a specific amount of tax law net income to a particular beneficiary with absolute certainty e.g. the maximum amount to a child which escapes the punitive rates under Division 6AA of the 1936 Act. This issue is illustrated in the Examples which follow.

4.37 Fourthly, the High Court decision says nothing about streaming of trust income. The matter was not in issue. The uncertainty about streaming of income according to its character remained unabated, until the Streaming Amendments.

4.38 Finally, the ATO has done away with the benevolent "capital beneficiary" approach set out in Practice Statement PSLA 2005/1 (GA) on and from 13 October 2010.

Examples

4.39 The best way to illustrate these points is by way of example. In the examples which follow the following facts apply in relation to the A Family Trust for the income year ended 30 June 2010:

Receipts:

rent	$50,000
net capital gain	$100,000

Expenses:

rental expenses	$10,000
interest	$20,000

4.40 The interest relates to the rental property only. The discountable capital gain was made on the sale of shares in a listed company. The intended beneficiaries are Mr and Mrs A and their two children both under 18.

4.41 Because of the low income rebate the following no-tax thresholds apply to minors:

Income Year end 30 June	**$**
2010	3,000
2011	3,333

4.42 If the income constitutes fully franked dividends the cash payment thresholds and grossed up taxable income amounts are:

Income Year end 30 June	**$ cash**	**$ taxable income**
2010	6,300	9,000
2011	7,000	10,000

4.43 These figures have considerable significance for trustees seeking to hit the no tax "sweet spot" for a distribution to a child.

(a) Subsection 95(1) terms apply – no "balance approach"

4.44 The taxable capital gain is $50,000. Accordingly, the distributable trust income is $70,000.

4.45 For 2010 a minor may be distributed $3,000 with no tax liability if entitled to the low income rebate (see comments above).

4.46 The trust distribution minutes might give effect to the following:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000

70,000

4.47 The tax law results will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.48 The cash in the trust will include the $50,000 covered by the 50% general CGT discount. This is not income and can be dealt with as capital. As this is a discretionary trust it can be distributed without tax consequences.

(b) Ordinary income applies – no "balance approach"

4.49 In this instance the trust distribution minutes will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	7,000
Mr A	7,000
	20,000

4.50 The tax law results will be:

	$
Child 1	$3{,}000 + {}^{3,000}/_{20,000} \times \$50{,}000$
Child 2	$3{,}000 + {}^{3,000}/_{20,000} \times \$50{,}000$
Mrs A	$7{,}000 + {}^{7,000}/_{20,000} \times \$50{,}000$
Mr A	$7{,}000 + {}^{7,000}/_{20,000} \times \$50{,}000$

4.51 The final results:

	$
Child 1	10,500
Child 2	10,500
Mrs A	24,500

Mr A	24,500
	70,000

4.52 This is a strict application of the proportionate approach.

4.53 Each of the children will pay tax on $7,500 at the Division 6AA punitive rates of 45%. This is not a good result.

(c) Subsection 95(1) applies – "balance approach" used

4.54 Trust minutes:

	$
Child 1	3,000
Child 2	3,000
Mrs A	half of the balance
Mr A	half of the balance

4.55 Trust income entitlements:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.56 The tax law result:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.57 This is the same outcome as where no "balance approach" is applied – but see below for the effect of a tax adjustment.

(d) Ordinary income applies – "balance approach" used

4.58 Trust minutes

	$
Child 1	3,000
Child 2	3,000
Mrs A	half of the balance
Mr A	half of the balance

4.59 Trust income created will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	7,000
Mr A	7,000
	20,000

4.60 The tax law results will be:

	$
Child 1	$3{,}000 + {}^{3,000}/_{20,000} \times \$50{,}000$
Child 2	$3{,}000 + {}^{3,000}/_{20,000} \times \$50{,}000$
Mrs A	$7{,}000 + {}^{7,000}/_{20,000} \times \$50{,}000$
Mr A	$7{,}000 + {}^{7,000}/_{20,000} \times \$50{,}000$

4.61 The final results:

	$
Child 1	10,500
Child 2	10,500
Mrs A	24,500
Mr A	24,500
	70,000

4.62 Again there is no difference. However, the "balance approach" is more realistic because it is unlikely that the trust income or tax law income will be known as at any 30 June. In reality these figures are not known until the accounts are drawn later in the calendar year.

(e) Tax Law Adjustments

4.63 It is often important to anticipate an adjustment to the trust's tax law income especially where there is something contentions going on.

4.64 As has been seen the tax law result will follow on a proportionate basis the entitlements to income created under the Deed. To test the outcome it is assumed in the above examples that the trustee failed to recognise $10,000 of rental income (say the trustee at first considered that the income was to be deferred until the 2011 income year) but was in fact wrong about this.

4.65 How do the various approaches deal with such an adjustment?

Example (a) – subsection 95(1) applies (but no "balance approach")

4.66 The trust law entitlements and tax law results were the same:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.67 The tax law adjustment will increase both the trust law entitlement and the tax law income by $10,000. The Trustee has not dealt with this $10,000 and, without an operative default beneficiary clause, it will be assessed to the Trustee under section 99A of the 1936 Act.

4.68 The trust law entitlements and tax law result will be:

	$
Child 1	3000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
Trustee	10,000
	80,000

4.69 However, if there is no streaming of the capital gain (with the effect that all beneficiaries are entitled to a proportionate part of the capital gain) that part of the capital gain reflected in the income to which no beneficiary is presently entitled will be grossed up for the loss of the 50% general CGT discount. Five eighths of the $10,000 adjustment assessed to the Trustee is capital gain. As a result the share of the net income assessable to the Trustee will be increased by $6,250.

4.70 The final result will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
Trustee	16,250
	86,250

4.71 This is a costly outcome.

Example (c) – subsection 95(1) but using a "balance approach".

4.72 The trust law entitlement and tax law result were the same.

	$
Child 1	3,000
Child 2	3,000
Mrs A	half of the balance
Mr A	half of the balance

4.73 The unadjusted result was:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.74 The adjusted trust law entitlement and tax law result will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000 + 5,000
Mr A	32,000 +5,000
	80,000

4.75 The "balance approach" together with adoption of s 95(1) terms directs all of the tax law result from an adjustment made by the ATO to the balance beneficiaries.

4.76 If the balance distribution has been used Mr and Mrs A will "enjoy" a further $5,000 of income entitlement (it now having been correctly determined) and a further $5,000 of tax law net income each. No amount will be assessed to the trustee.

4.77 There is an argument that the beneficiaries have not become presently entitled to the amount of the adjustment to the trust law net income as it was not ascertained at the end of the income year. In the writer's opinion the trust law net income was always the amount as correctly adjusted by the ATO. There was never any uncertainty about it. It is simply the case that the trustee and ATO had not properly determined the correct quantum of income.

4.78 In practical terms how have the Courts looked at the "balance approach"? It has not come up that often.

4.79 The decision of Cooper J in *BRK (Bris) Pty Ltd v C of T* [2001] FCA 164 might at first blush give cause for concern. There the Court considered the operation of the default beneficiary clause in the Trust Deed. The distributions had been:

1993 income year:

"Hendon Unit Trust 100%

and Resolved that should the Commissioner of Taxation disallow any amount as a deduction or include any amount in the assessable income of the Trust, such amount or amounts are to be deemed distributed on 30th June 1993 in the same proportions as listed above to the beneficiaries listed above".

1994 income year:

(a) The sum of $304,021.72 to Westside Commercial Centre Pty Ltd as trustee of the Hendon Unit Trust for its absolute benefit.

(b) The following sums to the following beneficiaries for their absolute respective benefits: NIL

(c) The Balance to Jessica Wagner and Bill Wagner equally between them for their absolute benefit.

1995 income year:

Hendon Unit Trust	*First $220,000*
Northbourne Trust	*Next $100,000*

Wilhelm J Wagner and Jessica O Wagner	*Remainder of balance equally*

4.80 The same "variation of income" clause as in 1993 applied in this year.

4.81 It would appear that the Trust Deed did not adopt subsection 95(1) terms and that income was ordinary income.

4.82 It was found that the Hendon Unit Trust was not an object of the Trust and the distribution of income to it failed. The default beneficiaries clause distributed income in default of appointment to the beneficiaries described in the Schedule to the Deed as tenants in common. This was the usual wide class of family objects.

4.83 The Court concluded that the default beneficiary clause did not operate as at 30 June because the trustee had a reasonable time after the end of the income year in which to decide to distributed or accumulate.

4.84 The question arose as to whether the balance clause in the 1994 and 1995 determinations operated to take the amounts which the Trustee had attempted to distribute to the Hendon Unit Trust to Mr and Mrs Wagner. It was concluded that this was not the effect of the distribution minute and, as a result, the Trustee was assessable under section 99A.

4.85 At [40] Cooper J concluded:

> *"In my judgment the submission is misconceived. In the 1994 income year the clear intention of the applicant was to appoint to Mr and Mrs Wagner only so much of the Trust income, if any, as exceeded $304,021.72 in addition to any income in excess of that amount in the event that the appointment to WCC should fail. The position is no different in respect of the 1995 year. The trustee purported to appoint discrete amounts of income to the Hendon Unit Trust as to the first $220,000 and to the Northbourne Trust as the next $100,000. Finally, as to any remainder after the application of the first $320,000 of income, that remainder was to be appointed to Mr and Mrs Wagner; they did not as a matter of construction or intention on the part of the trustee, take by default all of the income in the event of failure of the other two appointments."*

4.86 Rather than being a cause for concern about the "balance approach" the decision of Cooper J on this point supports its operation. The specific quantum entitlements fix the income (and tax where s 95(1) terms apply) at the amount specified in the Trustee's determination. If the gift fails it does not flow to the balance beneficiary but to the default beneficiary or, in the alternative, there is no such entitlement created, giving rise to a s 99A assessment to the trustee.

4.87 Further comfort can be obtained from observations made in *C of T v Ramsden* [2005] FCAFC 39. In that case the Court was concerned with the issue whether a beneficiary had effectively renounced a distribution of income.

4.88 The distribution minutes for the 1996 income year provided:

"Steve Hart Family Holdings No.2	*$17,295*
Steve Hart Family Holdings No.3	*$6,639*
Unlimited Aerobatic Discretionary Trust	*$34,810*
The Adcock Practice Trust	*$429,000*
Troy B Hart	*$4,750*
Steven I Hart	*The Balance"*

4.89 It was agreed that the Adcock Practice Trust did not qualify as a beneficiary. The default beneficiary clause provided for income which had not been appointed prior to year end to be held for Steven Hart and his three children as tenants in common. The ATO assessed each of the default beneficiaries to one quarter of the amount which had failed to be appointed to the Adcock Practice Trust.

4.90 The argument was pressed before the primary judge that the income should pass by way of the balance distribution to Steven Hart: Ramsden at [38] to [41]. Justice Spender's rejection of this argument was confirmed by the Full Court. It was observed at [2005] FCAFC 39 at [72]:

> *"We agree with this construction. 'The Balance' does not include the amounts which precede "The Balance" in the resolution of 30 June 1996.*
>
> *'The Balance' is the Income of the Trust for the year ended 30 June 1996 other than the amounts which precede it in the resolution in question, whether effectively appointed or not".*[2]

4.91 This observation supports the "balance approach" taken in this paper where there have been effective distributions. Note, however, that it will not work where a distribution is ineffective. In such a case the adjustment will be assessed to the default beneficiary, if there is one, or to the trustee.

Example (d) – Ordinary Income with balance approach applying

4.92 The trust law entitlements were:

	$
Child 1	3,000

[2] [2005] FCAFC 39 at para. 72.

Child 2	3,000
Mrs A	half of the balance
Mr A	half of the balance

4.93 Trust income entitlements:

	$
Child 1	3,000
Child 2	3,000
Mrs A	7,000
Mr A	7,000
	20,000

4.94 The tax law result was:

	$
Child 1	10,500
Child 2	10,500
Mrs A	24,500
Mr A	24,500
	70,000

4.95 When the tax law income is adjusted by $10,000 there is no change to the trust law result. The tax law result will be:

	$
Child 1	$10,500 + {}^{10,500}/_{70,000} \times \$10,000$
Child 2	$10,500 + {}^{10,500}/_{70,000} \times \$10,000$
Mrs A	$24,500 + {}^{24,500}/_{70,000} \times \$10,000$
Mr A	$24,500 + {}^{24,500}/_{70,000} \times \$10,000$

4.96 The final result will be:

	$
Child 1	12,000
Child 2	12,000
Mrs A	28,000
Mr A	28,000

	80,000

4.97 The result has only become worse from a Division 6AA income perspective.

Will a "default beneficiary" clause in the Deed assist?

4.98 An income default beneficiary clause would be expressed something like:

> *"If the Trustee has not determined to distribute all of the net income of the Trust by the end of the Income Year the Income Default Beneficiary will be absolutely entitled to that part of the net income which has not been distributed."*

4.99 The term "Income Default Beneficiary" will be appropriately defined to identify individuals or companies.

4.100 In Example (a) – subsection 95(1) terms but no "balance approach" – a default beneficiary clause would have deflected the tax adjustment from the trustee to the default beneficiary.

4.101 In Example (b) – ordinary income but no "balance approach" – the default beneficiary clause would have no effective operation as all of the trust law/tax law income has been accounted for.

4.102 The trust entitlements were:

	$
Child 1	3,000
Child 2	3,000
Mrs A	7,000
Mr A	7,000
	20,000

4.103 The tax law result was:

	$
Child 1	10,500
Child 2	10,500
Mrs A	24,500
Mr A	24,500
	70,000

4.104 If the tax law income is increased by $10,000 the trust law income does not alter. The tax law adjustment is apportioned according to the trust law income apportionments, as follows:

	$
Child 1	10,500 + $^{3,000}/_{20,000}$ x 10,000
Child 2	10,500 + $^{3,000}/_{20,000}$ x 10,000
Mrs A	24,500 + $^{7,000}/_{20,000}$ x 10,000
Mr A	24,500 + $^{7,000}/_{20,000}$ x 10,000[3]
	70,000

4.105 The final tax results will be:

	$
Child 1	12,000
Child 2	12,000
Mrs A	28,000
Mr A	28,000
	80,000

4.106 In Example (c) – subsection 95(1) terms and a "balance approach" – the default beneficiary clause has no role to play because the adjustment will always be directed to the balance beneficiary.

4.107 In Example (d) – ordinary income and "balance approach" – the default beneficiary clause has no need to operate because the tax adjustment will simply be apportioned in accordance with the trust law entitlements which don't change.

Summary re Tax Adjustments

Trust Accounting Basis	Tax Law Income	Trust Income	Adjustment to (if no default beneficiary)	Adjustment to (if there is a default beneficiary)
subsection 95(1) – no "balance approach"	+ $100	+ $100	Trustee	Default Beneficiary
subsection 95(1) – "balance approach"	+ $100	+ $100	Balance Beneficiaries	Balance Beneficiaries
ordinary income – no "balance approach"	+ $100	no change	All Beneficiaries	All Beneficiaries
ordinary income – "balance approach"	+ $100	no change	All Beneficiaries	All Beneficiaries

[3] The proportions remain the same whether the trust law or tax law results are used.

Guidance from Bamford

4.108 As the High Court observed in Bamford at [17]:

> *"… both sides in argument on the present appeals accepted that whichever of the competing constructions of Div 6 were accepted examples could readily be given of apparent unfairness in the resulting administration of the legislation"*

4.109 In reaching the conclusion that the terms of the Trust Deed determine the trust income to which a beneficiary may be made entitled the High Court has gone very far towards resolving most of the problems and uncertainties which confronted practitioners and the trustees and beneficiaries they advise. With a good understanding of the terms of the Trust Deed as they effect trust distributions most distribution problems can be addressed.

4.110 As has been demonstrated in the above worked examples adopting a s 95(1) terms plus "balance approach" achieves the following:

4.110.1 the quantum of tax distribution to children can be locked in.

4.110.2 any "normal" tax adjustment will flow to the balance beneficiaries.

4.110.3 if used in conjunction with a default beneficiary clause ineffective distributions can also be dealt with.

4.111 The subsection 95(1) but without a "balance approach" can lead to:

4.111.1 an assessment of the tax adjustments to the trustee under section 99A;

4.111.2 clawback of any general CGT discount.

4.112 This can be addressed by using a default beneficiary (of course the default beneficiary should not be a company where the general CGT discount is involved).

4.113 The balance approach together with a considered default beneficiary is to be preferred as the outcome is more predictable.

4.114 The ordinary income approach is problematic because it is:

4.114.1 too difficult to calculate what is net ordinary income;

4.114.2 and tax law adjustments will be spread across all beneficiaries (as there is no adjustment to the net income).

5. Div 7A Amendments

5.1 Division 7A of Part III of the 1936 Act deals with accessing wealth in private companies without accounting for the tax that would otherwise be payable on the value accessed. It focuses on three means of accessing wealth in private companies – payments from a private company, loans from a private company or the forgiveness of a debt by a private company to an associate of that company.

5.2 In 2010 there were two broad changes to the Division 7A interacts with trusts:

5.2.1 The Div 7A Amendments; and

5.2.2 The Commissioner's position in *Taxation Ruling 2010/3* and *Practice Statement Law Administration* 2010/4.

5.3 The changes to Division 7A include the insertion of an introductory note to Division 7A stating:

> An amount may also be included in the assessable income of a shareholder or shareholder's associate if:
>
> (a) a company has an unpaid present entitlement to income of a trust; and
>
> (b) the trustee makes a payment or loan to, or forgives a debt of, the shareholder or associate.
>
> (See Subdivisions EA and EB.)

5.4 This note is of interest as it strongly suggests that Subdivision EA is a 'code' which is intended to capture arrangements where there is an unpaid present entitlement subsisting between a trust and a corporate beneficiary and there is then a loan, payment or forgiveness that occurs between the trustee and a shareholder or an associate of a shareholder in the corporate beneficiary.

5.5 This should be contrasted with the position in the ATO *Taxation Ruling* 2010/3 where the ATO assert that subdivision EA has much more limited effect, where they generally restrict its operation to the situation where there is a sub-trust in existence between a trustee and a corporate beneficiary and there is then loan, payment or forgiveness involving a shareholder or an associate of a shareholder and the trustee of the sub-trust.

5.6 In the 31 March 2010 NTLG meeting the professional bodies questioned the ATO as to whether the introduction of this provision into Division 7A cast doubt on the position in their draft ruling. The meeting agenda includes the following discussion:

> The ATO does not see a conflict between the legislation of provisions dealing with unpaid present entitlements and the position set out in Draft Ruling TR 2009/D8.

This is because, contrary to the premise of the question, under Draft Ruling TR 2009/D8 unpaid present entitlements will retain that status for Division 7A purposes in many situations, including where:

- the amount representing the UPE is physically held on sub-trust for the sole benefit of the private company beneficiary;
- the amount representing the UPE is being used by the trustee but all benefits from this use are held for the sole benefit of the private company; or
- the private company beneficiary is not aware and cannot be taken to be aware that the funds representing its UPE are being used for the potential benefit of any or all discretionary objects of the trust (rather than being physically set aside or used for its sole benefit).

The ATO has appropriately consulted with Treasury prior to and during the drafting of TR 2009/D8.

Provisions within Division 7A dealing with unpaid present entitlements will continue to have their intended application and there is no inconsistency between the Exposure Draft legislation and the draft Ruling.

Use of assets

5.7 As was announced in the 2009/10 Federal Budget the use of assets owned by private companies, or owned by trusts where there is a present entitlement owing to a private company may be subject to tax after 1 July 2009.

5.8 The way in which the use of assets will become subject to tax is through the amendment of the definition of the term 'payment' in Division 7A so that it extends to the provision of an asset (other than a transfer of property) for use by an entity. Consistent with the present operation of Division 7A the provision of the asset will only result in Division 7A consequences where the asset is provided to a shareholder or associate of a shareholder.

5.9 For the purposes of Division 7A the payment will occur when the use of the asset occurs.

5.10 A payment will also arise however where the asset is not used, but is available for use. The examples in the EM are illustrative of when it will be the right to use the asset, and not its use, that is subject to the Division 7A rules.

> ***Example (right to use from EM)***
> ***Brian is a shareholder of a private company that owns a luxury yacht. He does not have a formal agreement with the company in relation to the yacht, however, he takes the yacht out every second weekend.***
>
> ***Brian keeps the yacht at the company's business premises, but takes the key home. Brian stores several personal items on the yacht.***
>
> ***Brian's fortnightly use of the yacht is a payment under Division 7A. The availability of the yacht for Brian's use is also subject to Division 7A because the yacht is not readily available for use by the company. The company would need to arrange with Brian to***

get the key and for the removal of Brian's personal items before using the yacht. That is, the asset is available for Brian's use to the exclusion of the company.

Example (use from EM)
Marina is a shareholder of a private company that owns a city apartment. The apartment is generally available for rent. However, Marina asks the company not to rent the apartment out for a week so that she and her family can use the apartment over a long weekend. Marina's use of the apartment is a payment for the purposes of section 109CA.

5.11 An issue that arose on consultation over the draft legislation giving effect to these changes was whether the mere availability of assets to a shareholder or associate would result in the shareholder or associate being treated as having the asset available for their use. The EM again includes an example where there a payment is not taken to arise where an asset is available as a result of a general entitlement to use an asset without actual use of the asset.

Example (mere entitlement from EM)
Peter is a shareholder of a private company that owns five cars for company use. Shareholders and their associates have general permission to use the cars on weekends if they are not being used for company business. Peter regularly takes one of the cars home.

Peter's use of the car that he takes home will be subject to Division 7A. This will include driving the car (actual use) and the availability of the car for his use to the exclusion of the company, such as when it is parked at home, or at a restaurant that Peter is visiting.

Although Peter may have general permission to use all five of the cars, he does not use all of them for the purposes of Division 7A. The four cars that Peter leaves at the company premises are available for the company to loan to another shareholder, employee, customer, or other party. That is, these cars are not available to Peter to the exclusion of the company.

5.12 The EM also includes examples of where an asset is available to more than one shareholder or associate and it is necessary to determine who is taxed. The EM suggests and apportionment of the taxable value to the person who is the real recipient of the benefit. One example sets out that a minor that benefits should not be taken to receive a Division 7A payment, where another sets out that incidental use by a spouse of a vehicle provided to a shareholder would not result in the spouse being taxed on the benefit provided.

5.13 In valuing the payment taken to be made it will be the amount that would have been paid for the use of the asset in an arm's length dealing less any consideration paid that will be determined to be the payment for Division 7A purposes.

5.14 There are a number of exceptions from the payment provisions applying, including one not previously announced dealing with residential property:

5.14.1 Minor benefits – if the provision of the asset would have been a minor benefit under section 58P of the FBTAA had it been provided to an employee then the benefit will be disregarded for Division 7A purposes

5.14.2 Otherwise deductible payments – if a once off deduction would have been available to the shareholder or their associate in connection with the use of the asset then there will be no benefit to be taken into account for Division 7A purposes.

5.14.3 Dwellings – the use of a dwelling can be exempt where the following conditions are satisfied:

5.14.3.1 the entity or their associate is carrying on a business;

5.14.3.2 the entity or their associate uses or is granted or has a lease, licence or other right to use land, water or a building for the purpose of carrying on the business; and

5.14.3.3 the provision of the dwelling to the entity is connected with that use or with that lease, licence or other right to use the land, water or building to carry on the business.

5.14.4 Main residences – the provision of a dwelling that is a person's main residence does not result in a Division 7A payment where:

5.14.4.1 The provider of the dwelling is a private company;

5.14.4.2 The private company acquired the dwelling before 1 July 2009; and

5.14.4.3 The private company would pass COT from the time that the dwelling was acquired until the end of the time that a payment could be taken to be made under Division 7A.

5.14.5 Vacant land – if the exception for a dwelling or a main residence applies, it will extend to adjacent land in the same way as occurs in the main residence exemption.

Corporate limited partnerships

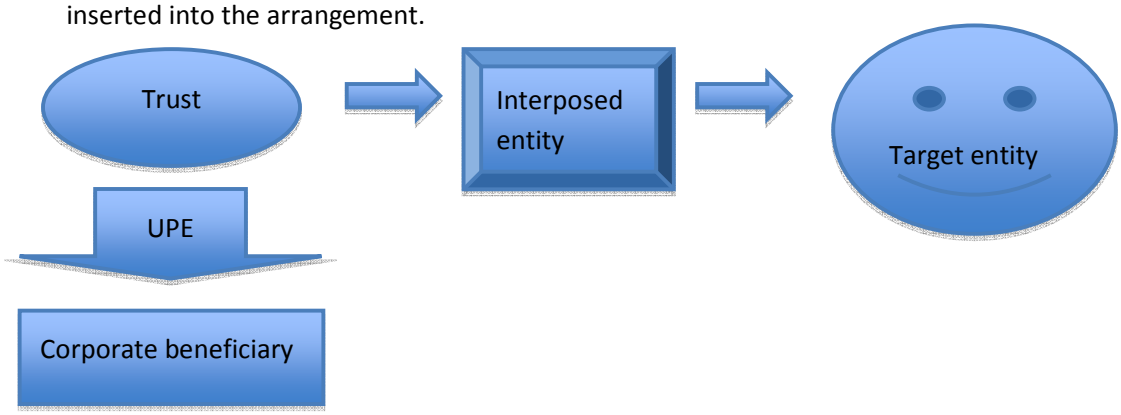
5.15 Closely held corporate limited partnerships (limited liability partnerships) will also now be subject to Division 7A. A corporate limited partnership will be closely held where it has fewer than 50 members or where an entity has, directly or indirectly, for the entity's own benefit, an entitlement to 75% or more of the income and capital of the partnership.

Interposed entities

5.16 The Div 7A Amendments fix two drafting issues in relation to the use of interposed entities.

5.17 The Division 7A legislation as originally drafted allowed for a payment by a private company through an interposed entity to be treated as a payment for Division 7A purposes.

5.18 The legislation did not however on a plain reading, allow for a trust where there was an unpaid present entitlement, to be deemed to have made a payment where an interposed entity was inserted into the arrangement.



5.19 A payment from the trust through an interposed entity to a target entity will now be caught by Division 7A if a reasonable person would consider that a loan or payment made to the interposed entity was made to enable a loan or payment to be made by the interposed entity to the target entity.

5.20 Consistent with the current operation of Subdivision EA however, a payment through to the target entity will only result in a Division 7A deemed dividend if it is referable to a reduction in a present entitlement that is in itself attributable to an unrealised gain in the trust.

5.21 The Div 7A Amendments also ensures that where an unpaid present entitlement is owed to a company by a trust, but the loan, payment or forgiveness that occurs does not involve the trust that owes the unpaid present entitlement, that Subdivision EA still has effect.

5.22 Subdivision EA will apply to treat a loan or payment from a trust as being a Division 7A loan or payment to the extent that the loan or payment is referable to an unpaid present entitlement owed to a private company where that amount has not already resulted in a Division 7A loan or payment.

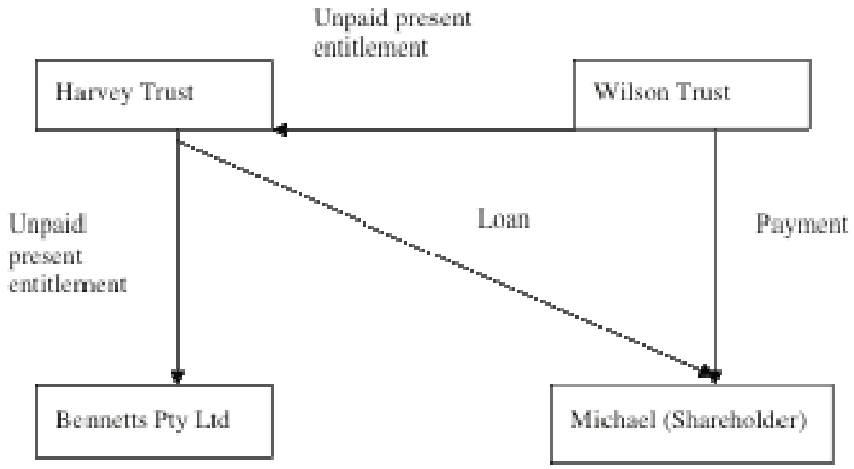
Example (interposed trust from EM)
Michael is a shareholder of Bennetts Pty Ltd and Bennetts Pty Ltd is a beneficiary of Harvey Trust. In the 2009-10 income year, Michael receives a payment from the trustee of the Wilson Trust, which is attributable to an unrealised gain. He receives this payment

because of his shareholding in Bennetts Pty Ltd. Michael also receives a $2,000 non-compliant Division 7A loan from the Harvey Trust.

Bennetts Pty Ltd is not presently entitled to an amount from the net income of the Wilson Trust. However, Bennetts Pty Ltd is entitled to $10,000 from the net income of the Harvey Trust (the first interposed trust) and Harvey Trust is presently entitled to $10,000 from the net income of the Wilson Trust. These amounts remain unpaid.

The loan made by the Harvey Trust to Michael will be included in Michael's assessable income under ordinary operation of subsection 109XA(2).

Bennetts Pty Ltd is taken to be presently entitled to $8,000 from the Wilson Trust, which is the unpaid present entitlement of $10,000 from the Harvey Trust, reduced by the $2,000 loan amount that is included in Michael's assessable income under another provision of Subdivision EA.



Loan back arrangements

5.23 Subdivision EA as currently drafted only captures payment arrangements where the payment is a reduction of a present entitlement that is referrable to an unrealised gain.

5.24 To circumvent these rules, apparently it had been suggested that the following arrangement could be entered into:

5.24.1 An unpaid present entitlement exists to a private company, say of $100,000.

5.24.2 A payment is made by the trustee of the trust to a beneficiary of an amount far in excess of the UPE, for example $1 million.

5.24.3 The amount in excess of the UPE is then loaned back to the trustee, being $900,000.

5.24.4 Thus, the beneficiary now has a credit loan of $900,000.

5.24.5 In future years the trustee appoints income to the company and uses the funds to repay the credit loan.

5.25 The need for there to be a payment referrable to a reduction of an unrealised gain will be removed where the payment made to a beneficiary is in reduction of a loan made on or after 1 July 2009 where a reasonable person would conclude that the trustee obtained the loan in order to make the payment.

Amendment to distributable surplus definition

5.26 The definition of distributable surplus will be amended so that amounts that have been deemed to be dividends as a result of the operation of Subdivision EA will be removed from the distributable surplus (by being correctly included as non-commercial loans).

Forgiveness of 109XB loans

5.27 There is a drafting problem that will be rectified so that the forgiveness of a loan by a trustee that has already been deemed to be a dividend will not result in a subsequent dividend. The law already applies in this way to the forgiveness of a debt owed to a private company by a shareholder that has already been deemed to receive a dividend under Division 7A.

Dividend set-off

5.28 Another drafting problem dealing with dividend set-offs will also be rectified.

5.29 At present, where a private company makes a loan that is deemed to be a dividend and later pays an unfranked dividend that is set off against that loan the later dividend is not included in assessable income.

5.30 The ability to disregard the later dividend does not apply where the loan was made by the trustee of a trust and where the deemed dividend arose under section 109XB.

5.31 The ability to disregard a later unfranked dividend offset against a loan from a trustee is being introduced.

Setting off employment entitlements

5.32 Another unusual aspect of the interaction of Division 7A generally and Subdivision EA has been that employment related payments that are offset against loans by trustees do not count as repayments if there is a borrowing of a similar or greater amount to the amount repaid. This is in contrast to setting off such a payment against a loan by a company where the repayment is taken into account even if there is a further borrowing.

5.33 This anomaly is to be rectified.

Borrowing to repay

5.34 Under the previous law a repayment is disregarded where the repayment is made where a reasonable person would conclude the repayment was made in order to borrow a similar or greater amount. This prevents a person from borrowing funds during a financial year, repaying on 30 June, and then reborrowing the amount on 1 July.

5.35 While the law has operated in this way (with some exceptions for repayments that occur by way of offsetting assessable amounts such as the wages noted above) it arguably has not operated where, instead of repaying to borrow, a person borrows to repay. This was be remedied so that a borrowing to repay will also activate section 109R.

> ***Example (from EM)***
> ***Alicia obtains a loan of $10,000 from Cleary Pty Ltd. Alicia has until the lodgment day to repay the loan. Two weeks before the lodgment day Alicia obtains a further $10,000 from Cleary Pty Ltd. She then repays the original $10,000 loan a week before the lodgment day.***
>
> ***The repayment of the original $10,000 loan is not a repayment for the purposes of section 109D, because Alicia has borrowed a similar amount from Cleary Pty Ltd and in this case a reasonable person would conclude that the loan was obtained in order to make the repayment of the original $10,000.***
>
> ***The original $10,000 loan is treated as a deemed dividend subject to the distributable surplus of the private company.***

Adding back payments for Division 7A purposes

6. Streaming

6.1 The paper will no consider the importance of, and ability to, stream as it stood before the Streaming Amendments. Then it will consider the Streaming Amendments.

Pre-Streaming Amendments

6.2 As can be seen from the illustrations above the ability to stream income according to its character is very important. This is particularly the case for franked dividends and capital gains but there are other forms of income with tax characteristics that may also be important e.g. income from a foreign source, income which has been subject to TFN withholding tax.

6.3 The decisions in Bamford tell us nothing about streaming income for tax purposes.

6.4 Most modern trust deeds will give the trustee power to distinguish between classes of income and to characterise a particular amount of income as having been derived from a particular source. The Deed should also allow the trustee to allocate expenses to the different classes of income.

6.5 The law regarding streaming after the decision in *CPT Custodian Pty Ltd v Commissioner of State Revenue [2005] HCA 53* ("**CPT Custodian**") was quite uncertain. The decision of the High Court in *Charles v C of T [1954] HCA 16* ("**Charles**") has always been the centre of gravity of the character flow through approach. The decision in Charles was heavily criticised by the Court in CPT Custodian. The question is whether that criticism went to the maintenance of character or is restricted to the characterisation of the interest in the trust fund by looking through to the underlying assets.

6.6 The decision of the High Court in CPT Custodian, in the writers' views, stands for the proposition that a beneficiary has an equitable interest in the residue of the trust fund after the Trustee's indemnity has been satisfied. This residue is characterless, whether it be income or capital, as the trustee may at any time satisfy its right to be indemnified from the receipts (which themselves have character).

6.7 Notwithstanding these problems the ATO has consistently taken the view that the character of the income in the hands of the beneficiary is taken from the character of the receipts of the Trustee[4] even after taking into account the decision in *CPT Custodian*[5].

6.8 In the non-binding ruling IT2328 (now withdrawn) it was observed:

> *"For income tax purposes where a beneficiary in a trust estate is presently entitled to the net income or a share of the net income of the trust estate, that income as a general principle has the same character in the hands of the beneficiary as it had in the hands of the trustee."*

6.9 The most significant streaming issues concern capital gains and dividends. In the case of capital gains Division 115 of Part 3-1 of the 1997 Act proceeds on an implication that income entitlements will take on at least some part of the character of the capital gains derived by the trustee. There is no clear legislative follow through. The guidance found in Sesction 115-200 of the 1997 Act establishes the implied maintenance of character:

> *"This Subdivision sets out rules for dealing with the net income of a trust that has a net capital gain. The rules treat parts of the net income attributable to the trust's net capital gain as capital gains made by the beneficiary entitled to those parts."*

[4] see in particular ATO ID 2008/51 dealing with Division 13.3A of the SIS Regulations.

[5] see Taxation Ruling STR 92/13, IT2328, IT2512, IT2004 (withdrawn) and ATO ID 2007/108 (which is concerned with foreign sourced income and in respect of which subsection 6B(2A) of the 1936 Act also comes into consideration).

6.10 Subsection 115-215(1) is the nub of the provisions:

> *"The purpose of this section is to ensure that appropriate amounts of the trust estate's net income attributable to the trust estate's capital gains are treated as a beneficiary's capital gains when assessing the beneficiary, so:*
>
> *(a) the beneficiary can apply capital losses against gains; and*
>
> *(b) the beneficiary can apply the appropriate discount percentage (if any) to gains."*

6.11 The process is described as attribution rather than maintenance of source character. This may be the necessary distinction to make the rules work. There is, however, no guidance about how the attribution is to be carried out.

6.12 What is clear is that if there is no trust income to which the beneficiary is presently entitled there can be no attribution. This is a major issue where there is no trading income but there are capital gains in the Trust. Use of s 95(1) terms to describe income overcomes this problem and makes the case for attribution much clearer. The capital gain (or at least 50% of it) will be included in the income. The connection for Subdivision 115-C purposes is very clear.

6.13 The ATO has had to resort to the artificiality of the "capital beneficiary approach" in PS LA 2005/1 (GA) to achieve this sensible outcome – but this practice statement was withdrawn following Bamford.

6.14 The issues with streaming can be readily appreciated in the context of capital gains and the 50% general CGT discount. The streaming issue is, of course, the denial of the 50% CGT general discount when a trust to company distribution is in play.

6.15 Maintaining the example used above in which there is a net capital gain of $100,000, and gross rental income of $50,0000 and net rental income of $20,000.

6.16 In this instance the trustee wishes to cause the capital gain to be assessed in the hands of an individual (say Mrs A) and the net rental income in the hands of a company, A Co. If it is assumed that the Trust Deed has all of the usual income characterisation and streaming provisions and the Deed adopts subsection 95(1) terms, the outcome readily appears.

6.17 The income entitlements are:

	$	
A Co	20,000	comprising net rental income
Mrs A	50,000	comprising the capital gain
	70,000	

6.18 If the ATO took the view that streaming was unobtainable the outcome would be:

	$	$ Total
A Co	5,714 + taxable capital gain $28,572	34,286
Mrs A	50,000	50,000
		84,286

6.19 The other area of concern is franking credits. At least there is a ruling on this aspect of streaming, *Taxation Ruling* 92/13 (repealed as of 22 June 2011 because of the Streaming Amendments). The provisions of Subdivision 207-B and in particular ss 207-45 to 207-57 are consistent with flow through of the franked character of a dividend.

6.20 The fact the Example set out immediately below s 207-35(3) of the 1997 Act depends on character maintenance. It is worthwhile setting this Example out in full:

> *"A franked distribution of $70 is made to the trustee of a trust in an income year. The trust also has $100 of assessable income from other sources. Under subsection (1) the trust's assessable income includes an additional amount of $30 (which is the franking credit on the distribution). The trust has a net income of $200 for that income year.*
>
> *There are 2 beneficiaries of the trust, P and Q, who are presently entitled to the trust's income. Under the trust deed, P is entitled to all of the franked distribution and Q is entitled to all other income.*
>
> *The distribution flows indirectly to P (as P is entitled to a share of that net income and has a 100% share of the distribution under section 207-55). P therefore has an amount of assessable income that is equal to its share of the distribution. Under this subsection, P's assessable income also includes the full amount of the franking credit (as P's share of the franking credit on the distribution is $30 under section 207-57). Q's share of the net income therefore does not include any of the franking credit."*

6.21 Clearly the legislation contemplates maintenance of character for the purposes of dividend imputation.

Commissioner's Concern of Division 6 Abuses

6.22 As usual the ATO is driven by the possibility that the decision in Bamford might support some abuse and revenue loss. No matter that their interpretations lead to massive headaches for practitioners.

6.23 This much is exampled by several examples set out *in Practice Statement PS LA 2009/7* which was released prior to the decision in Bamford.

6.24 Examples 1 and 5 in particular show what the ATO is on about.

6.25 Example 1 concerns the trustee of a family trust deriving $250,000 in income during the income year and applying that income to the purchase of a holiday home. The trustee, acting in accordance with a power expressed in the terms of the Trust Deed to do so, determines that the expenditure on the purchase of the house is an outgoing on income account with the effect that the trust law income available for distribution is $5,000. One of the beneficiaries has tax losses.

6.26 The trustee distributes the $5,000 trust law income to the loss beneficiary. The losses cover the tax law income which follows the trust law income to the loss beneficiary.

6.27 The ATO expresses concern about the mismatch of the actual amount to which the beneficiary becomes entitled ($5,000) and the amount of the tax law income flowing to the beneficiary ($250,000) and the tax not paid because of the losses.

6.28 It is difficult to say why this is of concern to them. The true effect of the transaction is to maintain $245,000 in the capital of the trust. The same tax effect would be obtained by distributing all of the $250,000 to the loss beneficiary. There is no tax difference in this illustration. It is unlikely there would be a tax benefit for the purposes of Part IVA. The most likely explanation for the transaction is the financial risk the loss beneficiary has been exposed to. If the beneficiary became entitled to call on the trustee to pay him or her $250,000 the creditors may be able to stake a claim to that amount. It is a neat and sensible piece of asset protection planning.

6.29 Example 5 is about a trust which has distinct income and capital beneficiaries. The trustee has a power to determine whether receipts and outgoings are on income or capital account. The Trust Deed is amended to admit a tax exempt entity as a beneficiary.

6.30 The trust derives $100,000 of income (meaning income according to ordinary concepts) during the income year. The trustee determines that $95,000 of that amount is a capital receipt. The remaining $5,000 is the trust law income according to the Trust Deed. This amount is appointed to the tax exempt beneficiary. All of the tax law income will be assessed to the charity. It would follow that the trustee makes a capital distribution of the $95,000 to a family beneficiary.

6.31 The ATO observe in the Practice Statement that Part IVA might apply in the circumstances. In the writer's view it almost certainly would do so in particular because of the amendment to introduce the tax exempt charity as a beneficiary and the fact that prior year distributions had been made only to family members. A much more challenging (and perhaps more realistic) illustration would arise if the tax exempt charity was already an object and the trustee had made distributions to charities in the past. The Part IVA case in such circumstances would be difficult to make out. This is an example of the acknowledged "apparent unfairness in the resulting administration of the legislation" as noted by the High Court in Bamford at [17].

6.32 The ATO apparently accept that Bamford authorizes characterization of capital receipts as income for the purposes of the Deed but are not so ready to accept that ordinary income may be recharacterised as capital (as in Example 5). They appear to be fortified in this by observations made by the Full Court of the Federal Court in *Forrest v C of T* [2010] FCAFC 6 ("**Forrest**").

6.33 The relevant question before the Court there was whether Mr Forrest was entitled to a deduction for interest he had incurred in relation to funds he had borrowed to acquire units in a unit trust. The outcome turned on whether there was a fixed income component to which the funds related. The Full Court concluded that a power to determine whether any amount received by the trustee was on revenue account or capital account (clause 12 of the Deed) was not a power to change the beneficiaries' rights. In so doing they observed at [11]-[12]:

> *'In our opinion, the power conferred by cl. 12 cannot be exercised by the trustee wrongly to classify a receipt as a capital gain, when the receipt is, in truth, income, and thus deprive the appellant of his interest in the unit component of the trust. Clause 12 is not an unlimited power to be exercised in the trustee's unconfined discretion….*
>
> *Clause 12.2(a) is a power to determine how a distribution to beneficiaries is classified. That limited power is not a power which is capable of altering the beneficiaries' rights. Clause 12 is to be read consistently with the balance of the Trust Deed and an appreciation that it contains various powers of an administrative character. The words used can be given full force honestly to classify income or distributions according to law, as the appellant contended to this Court".*

6.34 It is very difficult to know how far this goes. The issue in Forrest was about whether or not the exercise of the power changed the rights as between classes of beneficiaries. Presumably the ATO would say that the exercise of the power in a case like that in Example 5 was not an "honest" classification of the receipt as capital. Hopefully the issue will not arise very often.

Point of Interest

6.35 A case of interest is *Greenhatch v FCT* [2011] AATA 479 that ostensibly concerned superannuation contributions where the answer to the superannuation question was determined by construing streaming through a trust. The case of is interest for two reasons.

6.36 First, the AAT went out of their way to note the Commissioner's interpretation of Bamford was wrong. At [49] and [50] they said:

> *Much, if not all, of the Commissioner's case turns on his rejection of any underlying conduit theory and his interpretation of the implications of the decision in Bamford.*

The Commissioner's contention that the conduit theory has no role to play is based on foundations with which we do not agree. Accordingly, those foundations do not support the conclusion he seeks to draw.

6.37 Secondly, in relation to Subdivision 207-B of the 1997 Act, being the franking credits provisions, the AAT observed at [63]:

> *Section 207-35 of the 1997 Act has an aspect that makes the conclusion [that] amounts passing through trusts to beneficiaries thereof carry the character and identity that they had in the hands of the trustee more compelling. That section includes an example that contemplates differential distributions in determining the taxation burdens that are imposed on the beneficiaries of the trust.*

6.38 Question: was it necessary to introduce the Streaming Amendments in light of the above comments? Given we have the Streaming Amendments it is of academic interest only.

Streaming Amendments

6.39 The *Tax Laws Amendment (2011 Measures No. 5) Act* 2011 (Cth) was introduced into parliament (as a Bill) on 2 June 2011, was passed unamended and assented to on 29 June 2011. They take effect from 1 July 2010. These dates show how close a call it was as the Streaming Amendments are critical for trustee decisions that were needed to be made on 30 June 2011 – one day after their royal assent.

6.40 Subject to a statement by the Commissioner – extending the time a trustee could make decisions to 31 August 2011, which has anyway passed, but the writers question the Commissioner's ability to alter what trust law[6] requires to be done on 30 June of any year – the Streaming Amendments apply to trustees resolving to deal with trust income and capital gains.

6.41 From the 2011 income year and thereafter taxable capital gains and franked distributions are dealt with under these rules.

6.42 The Streaming Amendments operate by diverting from Division 6 of the 1936 Act the franked distributions and taxable capital gains. They are assessed directly in the hands of the beneficiaries who are presently entitled to them. They do this via Subdivision 207-B of the 1997 Act for franked distributions and via Subdivision 115-C of the 1997 Act for taxable capital gains. However, for the taxable capital gains they must still pass through the method statement in s 102-5(1) of the 1997 Act.

[6] *Trustees of the Estate Mortgage Fighting Fund Trust v FCT* [2000] FCA 981 per Hill J; *Case R105,* 84 ATC 692; *Antonopoulos v FCT* [2011] AATA 431.

6.43 The Streaming Amendments have introduced a new Division 6E into Part III of the 1936 Act to prevent double taxation. It adjusts the Division 6 income and net income of the trust to take out the amounts to which the beneficiary has been made specifically entitled.

6.44 It can be seen that the specific entitlement of the beneficiary or beneficiaries is the critical aspect of the Streaming Amendments. This is required to determine tax liability.

Specific Entitlement

6.45 The notion of a specific entitlement conceals the difficulties of applying the Streaming Amendments to all trusts, be they discretionary, fixed, unit, et cetera. The mechanism by which you become specifically entitled are set out in the relevant Subdivisions: s 115-228 for capital gains and s 207-58 for franked distributions. The provisions seem substantially similar at first look but there are some significant differences.

6.46 A beneficiary is specifically entitled under s 207-58 of the 1997 Act to an amount of a franked distribution made by the trust equal to the amount calculated under the following formula

$$\text{Franked Distribution} \times \frac{\text{Share of net financial benefit}}{\text{Net financial benefit}}$$

6.47 The "net financial benefit" is an amount equal to the financial benefit referable to the franked distribution (after an application by the trustee of expenses that are directly relevant to the franked distribution).

6.48 The term "financial benefit" is already in s 995-1 f the 1997 Act. It means anything of economic value, even if the transaction also imposes an obligation on the entity. Benefits and obligations are to be looked at separately and not set off against each other, but it is the net financial benefit to which the formula looks.

6.49 The "share of the financial benefit" is the amount of the financial benefit referable to the franked distribution specifically linked to the particular beneficiary. The share of the net financial benefit is:

> *… an amount equal to the *financial benefit that, in accordance with the terms of the trust:*
>
> *a. the beneficiary has received, or can be reasonably expected to receive, and*
>
> *b. is referable to the *franked distribution (after application by the trustee of any expenses that are directly relevant to the franked distribution) and*
>
> *c. is recorded, in its character as referable to the franked distribution, in the accounts or records of the trust no later than the end of the income year.*

6.50 Section 115-228 is identical to the discussion above of franked distributions, subject to:

6.50.1 the financial benefit must be referable to the capital gain "after application by the trustee of any losses, to the extent that the application is consistent with the application of capital losses against the capital gain in accordance with the method statement in subsection 102-5(1)"; and

6.50.2 the recording of the financial benefit must be "no later than 2 months after the end of the income year."

Complexities and Going Forward

6.51 An issue to be mindful of is – in fact an issue of significant importance – is that a trust with no "income", which was one of the problems in the Bamford appeals, will not be able to stream franking credits. This will mean that where the franked distributions, together with other ordinary income, is insufficient to more than offset expenses of the trust the franking credits cannot go through to the beneficiaries. The same restriction does not apply in relation to capital gains streamed through the trust.

6.52 Ken Schurgott FTIA, in his paper in the August 2011 *Taxation in Australia* titled "Trust streaming 2011" notes a number of complications that arise from the Streaming Amendments:

> *As will be seen, there are a number of issues which emerge that complicate the legislation over and beyond the rather simple approach adopted prior to the Commissioner's stance on streaming. The things which complicate matters are:*
>
> *a. There can be different outcomes according to the definition of income adopted by the trust deed;*
>
> *b. Significantly different outcomes can result where a beneficiary has not been made specifically entitled to the franked distribution or capital gain. This is most pronounced in relation to capital gains;*
>
> *c. The concept of making a beneficiary entitled to the entire financial benefit from a capital gain or franked distribution is fraught with difficulty, particularly where there are capital losses or directly related expenses; and*
>
> *d. The way in which capital losses and directly related expenses are to be dealt with is confusing.*

6.53 It can be seen from these further issues, and the problem of actually apply what is a simple concept of diverting the amounts to Subdivisions 115-C and 207-B respectively, are anything but straightforward or settled. Indeed, a senior council on the writer's floor, after having advised on

the Streaming Amendments is of the view that this is where future archeologists will find the bones of 21st Century tax lawyers and accountants.

7. Changes to the taxation of trusts – terms to be provided for in a trust document

7.1 Given the changes in the taxation of trusts, it is recommended that trust deed (or any other constituent documents) be reviewed so as to determine:

7.1.1 How income, capital gains and outgoings are accounted for and determined; and

7.1.2 How income, capital gains and outgoings are to be distributed.

7.2 Some of the powers which may be advantageous to have within a trust instrument include:

7.2.1 an accounting policy which is sufficiently broad and allows the trustee to exercise maximum discretion;

7.2.2 the discretion to reclassify and allocate income and capital gains;

7.2.3 the discretion to reclassify and allocate outgoings;

7.2.4 the discretion not to recoup losses (whether income or capital in nature);

7.2.5 the ability to allocate and stream classes of income and capital and their related tax attributes;

7.2.6 and ensure that any unpaid present entitlement / loan provisions are removed, and an ability to hold amounts subject to a sub-trust.

7.3 Some additional powers to be considered include:

7.3.1 whether the trustee has the power to distribute income and / or capital at any time within a tax year;

7.3.2 whether any determination of income (or capital) can be made within the income tax year; and

7.3.3 whether the trustee has a power to determine entitlements with respect to an income tax year after the relevant year.

Accounting policy

7.4 Essential is ensuring that the trust deed provides guidance with respect to an accounting policy that should be used by the trustee. Such an accounting policy should provide sufficient flexibility for the trustee, so that it may depart from generally accepted accounting standards in the event that the trustee considers that it is appropriate to do so.

Reclassifying and allocating income and capital

7.5 As the High Court in *Bamford* accepted that the tax law income of a trust is dependent upon (amongst other things) the definition of that term in the trust deed, regard should be given to the definition of the 'income' as contained in the trusts constituent documents.

7.6 An issue to consider is whether attributed amounts (e.g. franking credits) should be included within the definition of trust income. An issue that arises is that if attributions are included in trust income (and which are not physically 'paid' by a trustee – but which follow certain amounts of income), whether by being included in trust income, and thereby providing that a trustee creates a 'present entitlement' in a beneficiary to an amount that is never received by a trustee, the trustee will be exposed to a claim in relation to amounts that are not actually received by the trustee.

7.7 It is submitted that amounts such as franking credits should be prima facie carved-out of the definition of income. However, the definition should contain discretionary elements to allow a trustee to cause such 'attributed' amounts to fall within the definition of income.

7.8 An approach which may be considered is, in defining trust income:

7.8.1 Provide that it prima facie equals the amount provided for in s 95(1) of the 1936 Act (less any franking credits);

7.8.2 If the tax law approach is not warranted for a particular tax period, then:

7.8.2.1 According to an accounting policy adopted by the trustee; or

7.8.2.2 Any other basis as determined by the trustee; or

7.8.3 In the trustee's absolute discretion, the gross income of the trust.

Reclassifying and allocating outgoings

7.9 In *Cajkusic v FC of T (No 2)* (2006) ATC 4752 ("**Cajkusic**") deductions allowable to a family discretionary trust for payments that were made under an employee benefits trust arrangement in the income tax years ending 30 June 1997 and 30 June 2008 caused there to be a loss within the trust estate.

7.10 As a result of the losses, there was no distributable income of the trust. As a result, the Full Court of the Federal Court held that the lack of distributable income meant that there could be no beneficiary of the trust (for the relevant income tax years) to be "*… presently entitled …*'"pursuant to s 97 of the 1936 Act to any amount.

7.11 It should be noted that the Commissioner's subsequent application for special leave to appeal to the High Court was rejected.

7.12 Cajkusic stands for the proposition that the 'distributable income' of a trust is determined by reference to proper accounting principles, as well as the terms of a trust deed. In this context distributable income is income determined according to accounting principles, and which is distributable amongst the beneficiaries. It does not alter either the income as calculated under accounting principles, of the 'net income' as determined under s 95(1) of the 1936 Act – rather, only gives a trustee the power to determine the distributable amounts.

7.13 As a result of the decision in Cajkusic, it is submitted that a trust deed should give a trustee the power to reclassify, and allocate outgoings, so that there can be 'distributable income' to which beneficiaries are presently entitled.

Discretion not to recoup losses (whether income or capital in nature)

7.14 It is recommended that a trustee have a discretion not to recoup losses (whether of an income or capital nature). That is, a power not to recoup losses which have arisen in the past.

8. Resettlement considerations

8.1 Whenever the terms of a trust are varied, an issue to consider is whether the variation amounts to a 'resettlement'.

8.2 Resettlements relate to changes to a trust relationship which have the effect that a new trust estate comes into existence. According to the High Court in *FC of T v Commercial Nominees of Australia Ltd* [2001] HCA 33 (***"*Commercial Nominees"**), the issue to determine is whether '*… what occurred* … [i.e. the variation] … *was a fundamental alteration in the trust relationship*

established by the original deed, such that it destroyed the necessary continuity of the 'taxpayer'…'.

8.3 A resettlement can have significant income tax, capital gains tax (**'CGT'**) and stamp duty consequences, including that:

8.3.1 the trust property may be disposed of, potentially triggering both stamp duty and CGT liabilities;

8.3.2 carried forward tax benefits may be lost; and

8.3.3 beneficiaries may dispose of their interests in the original trust and acquire interest in a new trust.

8.4 Specifically in the context of CGT, a resettlement may cause either CGT event E1 (s 104-60 of the 1997 Act) or CGT event E2 (s 104-65 of the 1997 Act) to happen.

8.5 In August 2001 the issued a Statement of Principles entitled *Creation of a new trust* (the **"Statement**"). The Statement clarifies when, in the Commissioner's view, changes to a trust gives rise to a new trust. The Commissioner considers that a new trust estate arises where there is a 'fundamental change to a trust relationship' – ie, a change in the essential nature and character of the original trust relationship. Further, the Commissioner considers that a new trust (i.e. a resettlement) may arise in the following circumstances:

- a change in beneficial interest in trust property;
- a new class of beneficial interest (whether introduced or altered);
- a redefinition of the beneficiary class;
- changes in the terms of the trust or the rights or obligations of the trustee;
- changes in the nature of the trust property;
- additions of property which could amount to a new and separate settlement;
- depletion of trust property;
- a change in the termination date of the trust;
- a change in the trust that is not contemplated by the terms of the original trust;

- a change in the essential nature and purpose of the trust; and / or
- a merger of two or more trusts or a splitting of the trust.

8.6 The Commissioner considers that depending on their nature and extent, the above changes may either amount to:

8.6.1 a variation of a continuing trust; or

8.6.2 a fundamental change in the essential nature and character of the trust relationship. In such a case, the original trust may be brought to an end and a new trust created. Whether a new trust is created depends on the terms of the original trust and on the powers of the trustee.

8.7 The High Court in Commercial Nominees held that significant changes to a superannuation fund trust deed did not create a new trust, even though the amending deed had:

8.7.1 changed the name of, and appointed a new trustee to the fund;

8.7.2 introduced a new category of beneficiaries;

8.7.3 changed the fund from a defined benefit fund to an accumulation fund;

8.7.4 appointed a professional management company as administrator; and

8.7.5 allowed membership to be promoted to the public.

8.8 The High Court in *Commercial Nominees* considered that there were three main indicators of the continuity of a trust relationship, being:

8.8.1 the constitution of the trust;

8.8.2 the trust property; and

8.8.3 the membership of the trust.

8.9 Substantial changes any of the above may cause a resettlement.

8.10 The High Court considered that, in order to destroy the necessary continuity, changes in one or more of the above indicators must be such as to terminate the existence of the entity, or to produce the result that the particular trust does not derive the income in question. It was held that the changes made to the trust deed in question were not sufficient to destroy the continuity, primarily because the fund was at all times governed by the same deed, the trust property did not change, and the members before the amendment to the trust deed remained members afterwards. We consider that the amendments discussed above will not cause a resettlement.

8.11 The Commissioner notes in the Statement that administrative changes, such as re-defining trust income (without more) may not cause a resettlement (depending on the context) as it may be administrative in nature.

8.12 However, regard will need to be given to the implications to the membership (i.e. the beneficial entitlements) of the trust, and what implications such an amendment will have on the respective entitlements in a trust. For example, an important consideration will be determining how unallocated / undistributed income is to be dealt with. For example, is such income:

8.12.1 accumulated, and form part of the corpus of the relevant trust estate;

8.12.2 is it distributed to certain default beneficiaries; or

8.12.3 is it held on trust for a specific purpose (e.g. a charitable purpose).

Changes in the Taxation of Trusts

A paper presented by Michael Bennett and Denis Barlin at the NSW Young Lawyers CLE

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Michael Bennett E bennett@sevenwentworth.com.au D 8224 3055 M 0408 029 416
Denis Barlin E dbarlin@wenworthchambers.com.au D 9231 6646 M 0404 848 311

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1. General overview

1.1 The income years ended 30 June 2010 and, more particularly, 30 June 2011 have been very active for the taxation of trusts. Significant events in three areas of trust taxplay activity:

1.1.1 decisions of the Courts and principally the High Court's decision in *Commissioner of Taxation v Bamford* (2010) 240 CLR 481; (2010) 264 ALR 436; [2010] HCA 10 ("**Bamford**");

1.1.2 legislative changes, principally:

1.1.2.1 the new rules set out in *Tax Laws Amendment (2011 Measures No. 5) Act* 2011 (Cth) (the "**Streaming Amendments**") that deal with taxation of franking credits and capital gains in trusts; and

1.1.2.2 the new rules set out in the *Tax Laws Amendment (2010 Measures No. 2) Act* 2010 (Cth) that are principally about Division 7A of Part III of the *Income Tax Assessment Act* 1936 (Cth) (the "**1936 Act**") and companies providing rights to use property, but also contain some trust issues (the "**Div 7A Amendments**"); and

1.1.3 Australian Taxation Office ("**ATO**") activities principally the very controversial draft ruling on unpaid present entitlements, TR 2009/D8.

1.2 Some of these changes have overtaken themselves. For instance, there was at the time – and this paper includes – a discussion of streaming post Bamford (see **heading 4** below). That discussion should be read as having been overtaken by the Streaming Amendments (see **heading 5**).

1.3 And what's more the change is not over. Chapter 2 of the explanatory memorandum to the Bill that introduced the Steaming Amendments makes it clear that the streaming provisions have been introduced as an interim measure to deal with perceived anomalies in the taxation of capital gains and franked distributions pending a comprehensive review of Division 6 of Part II of the 1936 Act.

1.4 The changes made so far give rise to issues themselves and further consequential issues for trusts. In addressing the issues – both outlined above and the consequential issues – this paper will discuss:

1.4.1 Taxation of trusts generally;

1.4.2 The competing views before Bamford;

1.4.3 The context of Bamford and what it means for trusts;

1.4.4 Briefly (as it is not germane to the other issues raised in the paper) what are the Div 7A Amendments and what they mean for trusts;

1.4.5 What are the Steaming Amendments and what they mean for trust;

1.4.6 What a trust deed needs in light of those three issues; and

1.4.7 Amending trust deeds to deal with those three issues.

1.5 The issues are dealt with in this order as they are chronological to their occurring.

2. Taxation of Trusts

2.1 The provisions dealing with the taxation of trust income are contained in Division 6 of Part III of the 1936 Act (which comprises of sections 95 to 102).

2.2 As a result of the enactment of Streaming Amendments, regard should also be given to:

2.2.1 Subdivision 207-B of the *Income Tax Assessment Act* 1997 (Cth) (the "**1997 Act**") – which deals with franking credits obtained by a trust estate; and

2.2.2 Subdivision 115-C of the 1997 Act – which deals with the distribution of capital gains by a trust estate.

2.3 Chief Justice Latham in *Tindal v FC of T* (1946) 72 CLR 608 at 618 observed that the object of Division 6 of the 1936 Act is to "*… secure payment of tax upon the whole of the net income of a trust estate, either from a beneficiary or the trustee, whether the income is paid over to or on account of the beneficiary …*". Further, according to Emmett J in *Bamford v Federal Commissioner of Taxation* (2009) 176 FCR 250 "*… an important assumption underlying Division 6 …* [is] *… that a beneficiary who derives a share of the net income should be in a position to pay out of that income; otherwise, the beneficiary could be placed in a difficult position*."

2.4 The starting point in determining the taxation of trust income is s 97 of the 1936 Act. Relevantly, s 97(1) of the 1936 Act 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; and

(b) the exempt income of the beneficiary shall include:

(i) so much of the individual interest of the beneficiary in the exempt income of the trust estate as is attributable to a period when the beneficiary was a resident; and

(ii) so much of the individual interest of the beneficiary in the exempt 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;

except to the extent to which the exempt income to which that individual interest relates was taken into account in calculating the net income of the trust estate; and

(c) the non-assessable non-exempt income of the beneficiary shall include:

(i) so much of the individual interest of the beneficiary in the non-assessable non-exempt income of the trust estate as is attributable to a period when the beneficiary was a resident; and

(ii) so much of the individual interest of the beneficiary in the non-assessable non-exempt 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]

2.5 That is, s 97 of the 1936 Act provides that where a beneficiary, who is not under a legal disability is presently entitled to a "*… share of the income of the trust estate …*", the assessable income of:

2.5.1 a resident beneficiary includes the beneficiary's share of the '*… net income of the trust estate …*'; and

2.5.2 a non-resident beneficiary includes so much of the beneficiary's share of the net income of the trust as is attributable to sources in Australia.

2.6 It should be noted that the term "net income of the trust estate" for the purposes of s 97 of the 1936 Act is defined in s 95(1) of the 1936 Act. However, the term "*… the income of the trust estate …*" as contained in s 97 of the 1936 Act is not defined in the 1936 Act.

2.7 Subsection 95(1) of the 1936 Act defines the term 'net income', in relation to a trust estate as:

> ***net income**, 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 Division 393 of the Income Tax Assessment Act 1997 (Farm management deposits) 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.*

2.8 For completeness, it should be noted that:

2.8.1 s 98 of the 1936 Act provides that the trustee is liable to tax on behalf of a beneficiary where the beneficiary is presently entitled to a share of the income of a trust estate, but the beneficiary is under a legal disability;

2.8.2 ss 99 and 99A of the 1936 Act apply to subject the trustee to tax where there is some part of the net income of a trust estate that is not subject to tax under either of ss 97 or 98 of the 1936 Act. The difference as between s 99 and s 99A of the 1936 Act is the rate of tax applicable. Typically, the trustee will be subject to tax under section 99A of the 1936 Act at a penal rate of tax equal to the maximum rate of tax (currently 45%). However, the Commissioner has a discretion to apply s 99 of the 1936 Act in certain circumstances, in which case the trustee will be subject to tax at the normal marginal rates of tax.

3. The two competing views before the decision in Bamford

3.1 There has been, for some time, two competing views in the taxation of trust income – the proportionate view and the quantum view.

Proportionate approach

3.2 *David & Anor v FC of T* 89 ATC 4377 contains an example of the application of the proportionate approach (which according to the High Court's decision in Bamford, is the correct approach).

3.3 The proportionate view looks to the share (or proportion) of trust law income of a trust to which a beneficiary is "presently entitled", and then applies that share or proportion to the net income of a trust estate to calculate how much of the net income is to be included in the beneficiary's assessable income.

3.4 As an example, if a beneficiary is entitled to one half of the trust law income, then the beneficiary must include half of the net income in their assessable income – irrespective of whether it is more or less than the amount of the trust law income to which they are entitled.

(a) Implications if tax law income exceeds trust law income

3.5 Under this approach, a beneficiary who is "presently entitled" to trust law income may be required under s 97(1) of the 1936 Act to include in their assessable income an amount of net income which is greater than the amount of trust law income to which they are entitled, and to which has been paid or distributed to them.

3.6 That is, they may be subject to tax on amounts whish they will not receive, and are not entitled to actually receive.

3.7 This outcome seems to be contrary to the objectives of Division 6 of the 1936 Act as outlined by Emmett J in the Full Court of the Federal Court decision in *Bamford v Federal Commissioner of Taxation* (2009) 176 FCR 250 (discussed above).

(b) Implications if trust law income exceeds tax law income

3.8 However, where the net income of a trust estate for the purposes of s 95(1) of the 1936 Act is less than the trust law income, then a beneficiary who is "presently entitled" pursuant to s 97(1) of the 1936 Act will be required to include in their assessable income an amount which is less than the trust law income to which they will be entitled, and which will be paid to them.

3.9 As a result, an on the assumption that the beneficiaries are "presently entitled" to the whole of the trust law income, with the result that the whole of the "net income" of the

trust estate is included in their assessable income pursuant to s 97(1) of the 1936 Act, there can be no part of the net income to which ss 99 or 99A of the 1936 Act applies.

3.10 There is still a question as to whether, in these circumstances, the beneficiary must include the excess amount (i.e. the amount not included under s 97(1) of the 1936 Act) under some provision of the tax acts (e.g. CGT event E4 as contained in s 104-70 of the 1997 Act).

The quantum approach

3.11 The quantum approach (which is no longer good law) is based on the proposition that a beneficiary can only be presently entitled to such amount(s) of trust income as they actually receive.

3.12 Further, any part of the net income of the trust estate which exceeds the amount to which the beneficiary is presently entitled is not income to which the beneficiary is presently entitled to pursuant to s 97 of the 1936 Act, with the result that the trustee is subject to tax on it under s 99A of the 1936 Act (unless the Commissioner exercises it discretion to cause it to be subject to tax under s 99).

3.13 As with the proportionate approach, where the net income of the trust estate for s 95(1) of the 1936 Act purposes is less than the trust law income, such that the beneficiary receives an amount which is greater than the amount included in their assessable income, the question arises as to how the excess is to be taxed (if at all).

4. Bamford

4.1 Bamford was a much anticipated decision. In the view of some[1] the decision was a missed opportunity to settle an area of the trust law and tax law that has been crying out for correction: *Bamford* at [17] citing Hill J in *Davis v Federal Commissioner of Taxation* (1989) 86 ALR 195 at 230.

Background to Bamford

4.2 Mr and Mrs Bamford were beneficiaries of a discretionary trust known as the Bamford Trust (the "**Trust**"). The trustee of the Trust was P&D Bamford Enterprises Pty Ltd. Mr and Mrs Bamford were also the directors and employees of P&D Bamford Enterprises Pty Ltd.

[1] Slater QC *Taxation Trust Income After* Bamfor'ds *Case*, 26th National TIA Convention, 2-4 March 2011

4.3 During the 2000 income tax year, the Trust made a contribution to an offshore superannuation fund on behalf of Mr and Mrs Bamford. The contribution was sourced from borrowings by the corporate trustee, in its capacity as trustee of the Trust.

4.4 For the purposes of determining the "net income" of the Trust for the 2000 income tax year, the corporate trustee (in its capacity as trustee of the Trust) claimed a deduction for both the contribution made to the offshore superannuation fund, and the interest on the borrowed funds used to make the contribution. The total deduction claimed was $191,701.

4.5 After taking into account of the deductions, the "net income" of the Trust for that year was distributed to specified beneficiaries of the Trust. Included in the distribution were Mr and Mrs Bamford, who both had specified amounts distributed to them.

4.6 Specifically, for that income tax year (i.e. the 2000 income tax year), the trustee of the Trust allocated amounts to certain beneficiaries of the Trust, including a payment of $34,000 each to Mr and Mrs Bamford. However, the trustee of the Trust did not have sufficient funds to pay the full amount of $34,000, and instead paid them $33,872, being what the trustee of the Trust thought was the total remaining trust funds.

4.7 The amount initially distributed by the trustee of the Trust was $187,530.

4.8 In 2005, the Commissioner of Taxation applied the anti-avoidance provisions so as to disallow the deductions of the Trust (for the 2000 income tax year) for the superannuation contribution and the interest. As a result of the denial of the deductions, for the purposes of the 2000 income tax year the Trust's taxable income exceeded its accounting income.

4.9 The decision essentially dealt with two things:

4.9.1 whether the 'proportionate approach' applied in the event that tax law income exceeds accounting / trust income; and

4.9.2 whether the trust deed of the trust could characterise an amount of capital gains as income of the Trust.

Application of the proportionate view

4.10 As a result of the denial of the deduction, the Trust's taxable income increased by $191,000. The Commissioner issued amended income tax assessments to both Mr and Mrs Bamford. Pursuant to the assessments, the Commissioner contended that Mr and Mrs Bamford were liable to tax on the increased 'net income' of the Trust based on the proportionate share of the amount by which the taxable income of the trust exceeded the accounting income.

4.11 Indeed, the Commissioner sought to assess Mr and Mrs Bamford on an extra $34,624, on the basis that that amount represented the 'share' of the additional $191,000 as their share (i.e. 18%) of the previous amount (i.e. $187,530) actually distributed.

4.12 However, the taxpayers argued that they should only be taxed on the difference between the $33,872 which they actually received, and the specific amount of $34,000 which was originally allocated to them (i.e. an amount of $128 each).

4.13 The High Court rejected the taxpayer's argument, and in doing so applied the "proportionate approach".

4.14 The High Court took a two step approach in dealing with this issue:

4.14.1 First – the High Court held that the term "*… income of the trust estate …*" as contained in s 97(1) of the 1936 Act refers to distributable income, being income as determined by the trustee taking into account the terms of the trust (e.g. the trust deed) and appropriate accounting principles.

4.14.2 Secondly – after ascertaining the "share" of the distributable income to which a beneficiary is presently entitled, s 97(1) of the 1936 Act then requires that "*… that share of the net income of the trust estate …*" be ascertained, being the shares of the taxable income and not the distributable income.

4.15 Further, it was held that the inclusion within s 97(1) of the 1936 Act of the defined phrase "*… net income of the trust estate …*" and the undefined term "*… the income of …* [the] *… trust estate …*" indicated that these were intended to have different meanings. As a result, the term "*… the income of …* [the] *… trust estate* " had a different and defined meaning for taxation purposes.

4.16 The Court at [45] held that the analysis of Sundberg J in *Zeta Force Pty Ltd v Commissioner of Taxation* (1998) 84 FCR 70 at 74-75 should be applied:

> *The resolution of the second issue of construction is to be found in the analysis by Sundberg J in* Zeta Force Pty Ltd v Commissioner of Taxation *… . His Honour dealt with the first issue of construction to the same effect as that just explained, saying:*
>
> > *"The words 'income of the trust estate' in the opening part of s 97(1) refer to distributable income, that is to say income ascertained by the trustee according to appropriate accounting principles and the trust instrument. That the words have this meaning is confirmed by the use elsewhere in Div 6 of the contrasting expression 'net income of the trust estate'. The beneficiary's 'share' is his share of the distributable income."*
>
> *Sundberg J then continued:*
>
> > *"Having identified the share of the distributable income to which the beneficiary is presently entitled, s97(1) requires one to ascertain 'that share of the net income of the trust estate'. That share is included in the beneficiary's assessable income. The expression 'net income of the trust estate' in par (a)(i) has the meaning given it by s 95(1) – taxable income as opposed to distributable income. The words 'that share' in par (a)(i) refer*

back to the word 'share' in the expression 'a share of the income of the trust estate', and indicate that the same share is to be applied to an income amount calculated according to a different formula (taxable income as opposed to distributable income). Since the income amount may differ according to which formula is applied, the natural meaning to give to 'share' where it appears for the second time is 'proportion' rather than 'part' or 'portion'. When Parliament wanted to convey the latter meaning, as it did in ss 99 and 99A, it used the word 'part'.

The contrast between the expressions 'share of the income of the trust estate' and 'that share of the net income of the trust estate' shows that the draftsman has sought to relate the concept of present entitlement to distributable income, and not to taxable income, which is, after all, an artificial tax amount. Once the share of the distributable income to which the beneficiary is presently entitled is worked out, the notion of present entitlement has served its purpose, and the beneficiary is to be taxed on that share (or proportion) of the taxable income of the trust estate."

4.17 For the 2000 income year, the "net income" of the Trust included the amount of $191,701 which should not have been claimed as a deduction in the tax return of the Trust. As a result, the High Court held that the assessable income of Mr and Mrs Bamford should include a share of that amount, equivalent to the share they each received of the distributable income.

Whether the trust deed could re-characterise amounts

4.18 The trust deed of the Trust gave the trustee the discretion to determine whether a particular receipt should be treated as income or capital.

4.19 The trustee relied on this power to pass a resolution to distribute the first $60,000 of net income, "*… including …* [the] *…. capital gain …*" to Mr and Mrs Bamford in equal shares.

4.20 The Commissioner argued that the capital gain was not income of the Trust. Further, since there was no income, no beneficiary could be 'presently entitled' to the amount in question, the trustee of the Trust should be assessed at the special rates.

4.21 The High Court held that the term "income" as contained in s 99A of the 1936 Act should be interpreted as income of the trust estate, as understood in trust law.

4.22 As a result, the net capital gain of the Trust became the income of the Trust after the trustee exercised its discretion to characterise the capital gain as income of the Trust.

Outcome for Trust Distributions

4.23 There is no room for doubt that Bamford establishes that:

4.23.1 income of the trust estate identified in s 97(1) of 1936 Act is to be determined according to any directions set out in the Trust Deed;

4.23.2 the share of the net income attributable to a beneficiary is to be determined in the same proportions in which the beneficiary enjoys the present entitlement to the share of the income of the trust.

4.24 In this first regard, the Court made it clear that the general rules regarding apportionment between capital and income of receipts and outgoings was largely based on assumptions which could be displaced by the terms of the trust instrument: Bamford at [17]. The general law of trusts operates to give meaning to the term "the income of the trust estate".

4.25 The determination of present entitlement to a share of the income is a process of trust administration. The decision of the Full Court of the Federal Court in *C of T v Totledge Pty Ltd* (1982) 40 ALR 385 at 393 is quoted in support: Bamford at [39]. The High Court distinguished its own decision in *C of T v Australia and New Zealand Savings Bank Ltd* (1998) HCA 53 (Bamford at [39]) as not relevantly addressing the issue. Finally, the Court observed that the Commissioner's lack of consistency in wishing to exclude "statutory income" from "income of the trust estate" did not assist his argument that "income" means "income according to ordinary concepts": Bamford at [41].

4.26 On the meaning of the term "share of the net income" the High Court adopted the proportionate approach advocated by Sunberg J in *Zeta Force* (discussed above).

4.27 What does this translate into for trustees making decisions in respect of trust distributions for the 2010 income year?

4.28 There are a number of relevant observations to be made.

4.29 First, if the Trust Deed provides a formula for determining the income of the trust then that formula will determine the entitlement of the beneficiaries to income. If, for example, the Deed contains words to the following effect:

> *"The net income of the trust is an amount equal to the amount determined in accordance with subsection 95(1) of the* Income Tax Assessment Act 1936 *but reduced by any amount which would otherwise be included by application of Division 207 of the* Income Tax Assessment Act 1997*".*

4.30 Throughout this paper "subsection 95(1) terms" means an amount adjusted for the franking credit gross up. The issue of grossing up is considered below in the context of using the full tax exemption including the franking rebate available to children.

4.31 Leaving aside the elimination of any gross up for franking credits (which itself is affected by the Streaming Amendments as discussed below) the amount of net income for trust law purposes

will equal the tax law income. The two will coincide so that there should, in the ordinary course, be no amount assessable to the trustee under s 99A of the 1936 Act.

4.32 Secondly, if the Trust Deed is silent then "ordinary income" principles apply. Just what they are is difficult to say. The ATO has expressed the view that income of a trust is income according to ordinary principles. This is not the same thing as accounting income determined in accordance with accounting principles. It requires a dissection of receipts into:

4.32.1 income according to ordinary principles;

4.32.2 income which is not ordinary income;

4.32.3 capital receipts.

4.33 Following that dissection, the expenses must be apportioned accordingly.

4.34 This is, of course, all too much. Many trust deeds will have a clause like that in Bamford which allows the trustee to determine whether a receipt is capital or income. Others will have very broad powers allowing the trustee to determine the basis on which income of the trust is to be worked out.

4.35 If these powers exist they should be used to avoid uncertainty brought about by the "ordinary income" approach. If they do not exist then the deed should be to give the trustee such a power. Whether such an amendment will amount to a resettlement, which might have adverse capital gains tax (and stamp duty) consequences, is discussed at **paragraphs xx** below.

4.36 Thirdly, because the proportionate approach has prevailed, a strict application of that rule will mean that great care needs to be taken when seeking to direct a specific amount of tax law net income to a particular beneficiary with absolute certainty e.g. the maximum amount to a child which escapes the punitive rates under Division 6AA of the 1936 Act. This issue is illustrated in the Examples which follow.

4.37 Fourthly, the High Court decision says nothing about streaming of trust income. The matter was not in issue. The uncertainty about streaming of income according to its character remained unabated, until the Streaming Amendments.

4.38 Finally, the ATO has done away with the benevolent "capital beneficiary" approach set out in Practice Statement PSLA 2005/1 (GA) on and from 13 October 2010.

Examples

4.39 The best way to illustrate these points is by way of example. In the examples which follow the following facts apply in relation to the A Family Trust for the income year ended 30 June 2010:

Receipts:

rent	$50,000
net capital gain	$100,000

Expenses:

rental expenses	$10,000
interest	$20,000

4.40 The interest relates to the rental property only. The discountable capital gain was made on the sale of shares in a listed company. The intended beneficiaries are Mr and Mrs A and their two children both under 18.

4.41 Because of the low income rebate the following no-tax thresholds apply to minors:

Income Year end 30 June	**$**
2010	3,000
2011	3,333

4.42 If the income constitutes fully franked dividends the cash payment thresholds and grossed up taxable income amounts are:

Income Year end 30 June	**$ cash**	**$ taxable income**
2010	6,300	9,000
2011	7,000	10,000

4.43 These figures have considerable significance for trustees seeking to hit the no tax "sweet spot" for a distribution to a child.

(a) Subsection 95(1) terms apply – no "balance approach"

4.44 The taxable capital gain is $50,000. Accordingly, the distributable trust income is $70,000.

4.45 For 2010 a minor may be distributed $3,000 with no tax liability if entitled to the low income rebate (see comments above).

4.46 The trust distribution minutes might give effect to the following:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000

70,000

4.47 The tax law results will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.48 The cash in the trust will include the $50,000 covered by the 50% general CGT discount. This is not income and can be dealt with as capital. As this is a discretionary trust it can be distributed without tax consequences.

(b) Ordinary income applies – no "balance approach"

4.49 In this instance the trust distribution minutes will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	7,000
Mr A	7,000
	20,000

4.50 The tax law results will be:

	$
Child 1	$3{,}000 + {}^{3,000}/_{20,000} \times \$50{,}000$
Child 2	$3{,}000 + {}^{3,000}/_{20,000} \times \$50{,}000$
Mrs A	$7{,}000 + {}^{7,000}/_{20,000} \times \$50{,}000$
Mr A	$7{,}000 + {}^{7,000}/_{20,000} \times \$50{,}000$

4.51 The final results:

	$
Child 1	10,500
Child 2	10,500
Mrs A	24,500

Mr A	24,500
	70,000

4.52 This is a strict application of the proportionate approach.

4.53 Each of the children will pay tax on $7,500 at the Division 6AA punitive rates of 45%. This is not a good result.

(c) Subsection 95(1) applies – "balance approach" used

4.54 Trust minutes:

	$
Child 1	3,000
Child 2	3,000
Mrs A	half of the balance
Mr A	half of the balance

4.55 Trust income entitlements:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.56 The tax law result:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.57 This is the same outcome as where no "balance approach" is applied – but see below for the effect of a tax adjustment.

(d) Ordinary income applies – "balance approach" used

4.58 Trust minutes

	$
Child 1	3,000
Child 2	3,000
Mrs A	half of the balance
Mr A	half of the balance

4.59 Trust income created will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	7,000
Mr A	7,000
	20,000

4.60 The tax law results will be:

	$
Child 1	$3{,}000 + {}^{3,000}/_{20,000} \times \$50{,}000$
Child 2	$3{,}000 + {}^{3,000}/_{20,000} \times \$50{,}000$
Mrs A	$7{,}000 + {}^{7,000}/_{20,000} \times \$50{,}000$
Mr A	$7{,}000 + {}^{7,000}/_{20,000} \times \$50{,}000$

4.61 The final results:

	$
Child 1	10,500
Child 2	10,500
Mrs A	24,500
Mr A	24,500
	70,000

4.62 Again there is no difference. However, the "balance approach" is more realistic because it is unlikely that the trust income or tax law income will be known as at any 30 June. In reality these figures are not known until the accounts are drawn later in the calendar year.

(e) Tax Law Adjustments

4.63 It is often important to anticipate an adjustment to the trust's tax law income especially where there is something contentions going on.

4.64 As has been seen the tax law result will follow on a proportionate basis the entitlements to income created under the Deed. To test the outcome it is assumed in the above examples that the trustee failed to recognise $10,000 of rental income (say the trustee at first considered that the income was to be deferred until the 2011 income year) but was in fact wrong about this.

4.65 How do the various approaches deal with such an adjustment?

Example (a) – subsection 95(1) applies (but no "balance approach")

4.66 The trust law entitlements and tax law results were the same:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.67 The tax law adjustment will increase both the trust law entitlement and the tax law income by $10,000. The Trustee has not dealt with this $10,000 and, without an operative default beneficiary clause, it will be assessed to the Trustee under section 99A of the 1936 Act.

4.68 The trust law entitlements and tax law result will be:

	$
Child 1	3000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
Trustee	10,000
	80,000

4.69 However, if there is no streaming of the capital gain (with the effect that all beneficiaries are entitled to a proportionate part of the capital gain) that part of the capital gain reflected in the income to which no beneficiary is presently entitled will be grossed up for the loss of the 50% general CGT discount. Five eighths of the $10,000 adjustment assessed to the Trustee is capital gain. As a result the share of the net income assessable to the Trustee will be increased by $6,250.

4.70 The final result will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
Trustee	16,250
	86,250

4.71 This is a costly outcome.

Example (c) – subsection 95(1) but using a "balance approach".

4.72 The trust law entitlement and tax law result were the same.

	$
Child 1	3,000
Child 2	3,000
Mrs A	half of the balance
Mr A	half of the balance

4.73 The unadjusted result was:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.74 The adjusted trust law entitlement and tax law result will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000 + 5,000
Mr A	32,000 +5,000
	80,000

4.75 The "balance approach" together with adoption of s 95(1) terms directs all of the tax law result from an adjustment made by the ATO to the balance beneficiaries.

4.76 If the balance distribution has been used Mr and Mrs A will "enjoy" a further $5,000 of income entitlement (it now having been correctly determined) and a further $5,000 of tax law net income each. No amount will be assessed to the trustee.

4.77 There is an argument that the beneficiaries have not become presently entitled to the amount of the adjustment to the trust law net income as it was not ascertained at the end of the income year. In the writer's opinion the trust law net income was always the amount as correctly adjusted by the ATO. There was never any uncertainty about it. It is simply the case that the trustee and ATO had not properly determined the correct quantum of income.

4.78 In practical terms how have the Courts looked at the "balance approach"? It has not come up that often.

4.79 The decision of Cooper J in *BRK (Bris) Pty Ltd v C of T* [2001] FCA 164 might at first blush give cause for concern. There the Court considered the operation of the default beneficiary clause in the Trust Deed. The distributions had been:

1993 income year:

"Hendon Unit Trust 100%

and Resolved that should the Commissioner of Taxation disallow any amount as a deduction or include any amount in the assessable income of the Trust, such amount or amounts are to be deemed distributed on 30th June 1993 in the same proportions as listed above to the beneficiaries listed above".

1994 income year:

(a) The sum of $304,021.72 to Westside Commercial Centre Pty Ltd as trustee of the Hendon Unit Trust for its absolute benefit.

(b) The following sums to the following beneficiaries for their absolute respective benefits: NIL

(c) The Balance to Jessica Wagner and Bill Wagner equally between them for their absolute benefit.

1995 income year:

Hendon Unit Trust	*First $220,000*
Northbourne Trust	*Next $100,000*

Wilhelm J Wagner and Jessica O Wagner	*Remainder of balance equally*

4.80 The same "variation of income" clause as in 1993 applied in this year.

4.81 It would appear that the Trust Deed did not adopt subsection 95(1) terms and that income was ordinary income.

4.82 It was found that the Hendon Unit Trust was not an object of the Trust and the distribution of income to it failed. The default beneficiaries clause distributed income in default of appointment to the beneficiaries described in the Schedule to the Deed as tenants in common. This was the usual wide class of family objects.

4.83 The Court concluded that the default beneficiary clause did not operate as at 30 June because the trustee had a reasonable time after the end of the income year in which to decide to distributed or accumulate.

4.84 The question arose as to whether the balance clause in the 1994 and 1995 determinations operated to take the amounts which the Trustee had attempted to distribute to the Hendon Unit Trust to Mr and Mrs Wagner. It was concluded that this was not the effect of the distribution minute and, as a result, the Trustee was assessable under section 99A.

4.85 At [40] Cooper J concluded:

> *"In my judgment the submission is misconceived. In the 1994 income year the clear intention of the applicant was to appoint to Mr and Mrs Wagner only so much of the Trust income, if any, as exceeded $304,021.72 in addition to any income in excess of that amount in the event that the appointment to WCC should fail. The position is no different in respect of the 1995 year. The trustee purported to appoint discrete amounts of income to the Hendon Unit Trust as to the first $220,000 and to the Northbourne Trust as the next $100,000. Finally, as to any remainder after the application of the first $320,000 of income, that remainder was to be appointed to Mr and Mrs Wagner; they did not as a matter of construction or intention on the part of the trustee, take by default all of the income in the event of failure of the other two appointments."*

4.86 Rather than being a cause for concern about the "balance approach" the decision of Cooper J on this point supports its operation. The specific quantum entitlements fix the income (and tax where s 95(1) terms apply) at the amount specified in the Trustee's determination. If the gift fails it does not flow to the balance beneficiary but to the default beneficiary or, in the alternative, there is no such entitlement created, giving rise to a s 99A assessment to the trustee.

4.87 Further comfort can be obtained from observations made in *C of T v Ramsden* [2005] FCAFC 39. In that case the Court was concerned with the issue whether a beneficiary had effectively renounced a distribution of income.

4.88 The distribution minutes for the 1996 income year provided:

"Steve Hart Family Holdings No.2	*$17,295*
Steve Hart Family Holdings No.3	*$6,639*
Unlimited Aerobatic Discretionary Trust	*$34,810*
The Adcock Practice Trust	*$429,000*
Troy B Hart	*$4,750*
Steven I Hart	*The Balance"*

4.89 It was agreed that the Adcock Practice Trust did not qualify as a beneficiary. The default beneficiary clause provided for income which had not been appointed prior to year end to be held for Steven Hart and his three children as tenants in common. The ATO assessed each of the default beneficiaries to one quarter of the amount which had failed to be appointed to the Adcock Practice Trust.

4.90 The argument was pressed before the primary judge that the income should pass by way of the balance distribution to Steven Hart: Ramsden at [38] to [41]. Justice Spender's rejection of this argument was confirmed by the Full Court. It was observed at [2005] FCAFC 39 at [72]:

> *"We agree with this construction. 'The Balance' does not include the amounts which precede "The Balance" in the resolution of 30 June 1996.*
>
> *'The Balance' is the Income of the Trust for the year ended 30 June 1996 other than the amounts which precede it in the resolution in question, whether effectively appointed or not".*[2]

4.91 This observation supports the "balance approach" taken in this paper where there have been effective distributions. Note, however, that it will not work where a distribution is ineffective. In such a case the adjustment will be assessed to the default beneficiary, if there is one, or to the trustee.

Example (d) – Ordinary Income with balance approach applying

4.92 The trust law entitlements were:

	$
Child 1	3,000

[2] [2005] FCAFC 39 at para. 72.

Child 2	3,000
Mrs A	half of the balance
Mr A	half of the balance

4.93 Trust income entitlements:

	$
Child 1	3,000
Child 2	3,000
Mrs A	7,000
Mr A	7,000
	20,000

4.94 The tax law result was:

	$
Child 1	10,500
Child 2	10,500
Mrs A	24,500
Mr A	24,500
	70,000

4.95 When the tax law income is adjusted by $10,000 there is no change to the trust law result. The tax law result will be:

	$
Child 1	$10,500 + {}^{10,500}/_{70,000} \times \$10,000$
Child 2	$10,500 + {}^{10,500}/_{70,000} \times \$10,000$
Mrs A	$24,500 + {}^{24,500}/_{70,000} \times \$10,000$
Mr A	$24,500 + {}^{24,500}/_{70,000} \times \$10,000$

4.96 The final result will be:

	$
Child 1	12,000
Child 2	12,000
Mrs A	28,000
Mr A	28,000

	80,000

4.97 The result has only become worse from a Division 6AA income perspective.

Will a "default beneficiary" clause in the Deed assist?

4.98 An income default beneficiary clause would be expressed something like:

> *"If the Trustee has not determined to distribute all of the net income of the Trust by the end of the Income Year the Income Default Beneficiary will be absolutely entitled to that part of the net income which has not been distributed."*

4.99 The term "Income Default Beneficiary" will be appropriately defined to identify individuals or companies.

4.100 In Example (a) – subsection 95(1) terms but no "balance approach" – a default beneficiary clause would have deflected the tax adjustment from the trustee to the default beneficiary.

4.101 In Example (b) – ordinary income but no "balance approach" – the default beneficiary clause would have no effective operation as all of the trust law/tax law income has been accounted for.

4.102 The trust entitlements were:

	$
Child 1	3,000
Child 2	3,000
Mrs A	7,000
Mr A	7,000
	20,000

4.103 The tax law result was:

	$
Child 1	10,500
Child 2	10,500
Mrs A	24,500
Mr A	24,500
	70,000

4.104 If the tax law income is increased by $10,000 the trust law income does not alter. The tax law adjustment is apportioned according to the trust law income apportionments, as follows:

	$
Child 1	10,500 + $^{3,000}/_{20,000}$ x 10,000
Child 2	10,500 + $^{3,000}/_{20,000}$ x 10,000
Mrs A	24,500 + $^{7,000}/_{20,000}$ x 10,000
Mr A	24,500 + $^{7,000}/_{20,000}$ x 10,000[3]
	70,000

4.105 The final tax results will be:

	$
Child 1	12,000
Child 2	12,000
Mrs A	28,000
Mr A	28,000
	80,000

4.106 In Example (c) – subsection 95(1) terms and a "balance approach" – the default beneficiary clause has no role to play because the adjustment will always be directed to the balance beneficiary.

4.107 In Example (d) – ordinary income and "balance approach" – the default beneficiary clause has no need to operate because the tax adjustment will simply be apportioned in accordance with the trust law entitlements which don't change.

Summary re Tax Adjustments

Trust Accounting Basis	Tax Law Income	Trust Income	Adjustment to (if no default beneficiary)	Adjustment to (if there is a default beneficiary)
subsection 95(1) – no "balance approach"	+ $100	+ $100	Trustee	Default Beneficiary
subsection 95(1) – "balance approach"	+ $100	+ $100	Balance Beneficiaries	Balance Beneficiaries
ordinary income – no "balance approach"	+ $100	no change	All Beneficiaries	All Beneficiaries
ordinary income – "balance approach"	+ $100	no change	All Beneficiaries	All Beneficiaries

[3] The proportions remain the same whether the trust law or tax law results are used.

Guidance from Bamford

4.108 As the High Court observed in Bamford at [17]:

> *"… both sides in argument on the present appeals accepted that whichever of the competing constructions of Div 6 were accepted examples could readily be given of apparent unfairness in the resulting administration of the legislation"*

4.109 In reaching the conclusion that the terms of the Trust Deed determine the trust income to which a beneficiary may be made entitled the High Court has gone very far towards resolving most of the problems and uncertainties which confronted practitioners and the trustees and beneficiaries they advise. With a good understanding of the terms of the Trust Deed as they effect trust distributions most distribution problems can be addressed.

4.110 As has been demonstrated in the above worked examples adopting a s 95(1) terms plus "balance approach" achieves the following:

4.110.1 the quantum of tax distribution to children can be locked in.

4.110.2 any "normal" tax adjustment will flow to the balance beneficiaries.

4.110.3 if used in conjunction with a default beneficiary clause ineffective distributions can also be dealt with.

4.111 The subsection 95(1) but without a "balance approach" can lead to:

4.111.1 an assessment of the tax adjustments to the trustee under section 99A;

4.111.2 clawback of any general CGT discount.

4.112 This can be addressed by using a default beneficiary (of course the default beneficiary should not be a company where the general CGT discount is involved).

4.113 The balance approach together with a considered default beneficiary is to be preferred as the outcome is more predictable.

4.114 The ordinary income approach is problematic because it is:

4.114.1 too difficult to calculate what is net ordinary income;

4.114.2 and tax law adjustments will be spread across all beneficiaries (as there is no adjustment to the net income).

5. Div 7A Amendments

5.1 Division 7A of Part III of the 1936 Act deals with accessing wealth in private companies without accounting for the tax that would otherwise be payable on the value accessed. It focuses on three means of accessing wealth in private companies – payments from a private company, loans from a private company or the forgiveness of a debt by a private company to an associate of that company.

5.2 In 2010 there were two broad changes to the Division 7A interacts with trusts:

5.2.1 The Div 7A Amendments; and

5.2.2 The Commissioner's position in *Taxation Ruling 2010/3* and *Practice Statement Law Administration* 2010/4.

5.3 The changes to Division 7A include the insertion of an introductory note to Division 7A stating:

> An amount may also be included in the assessable income of a shareholder or shareholder's associate if:
>
> (a) a company has an unpaid present entitlement to income of a trust; and
>
> (b) the trustee makes a payment or loan to, or forgives a debt of, the shareholder or associate.
>
> (See Subdivisions EA and EB.)

5.4 This note is of interest as it strongly suggests that Subdivision EA is a 'code' which is intended to capture arrangements where there is an unpaid present entitlement subsisting between a trust and a corporate beneficiary and there is then a loan, payment or forgiveness that occurs between the trustee and a shareholder or an associate of a shareholder in the corporate beneficiary.

5.5 This should be contrasted with the position in the ATO *Taxation Ruling* 2010/3 where the ATO assert that subdivision EA has much more limited effect, where they generally restrict its operation to the situation where there is a sub-trust in existence between a trustee and a corporate beneficiary and there is then loan, payment or forgiveness involving a shareholder or an associate of a shareholder and the trustee of the sub-trust.

5.6 In the 31 March 2010 NTLG meeting the professional bodies questioned the ATO as to whether the introduction of this provision into Division 7A cast doubt on the position in their draft ruling. The meeting agenda includes the following discussion:

> The ATO does not see a conflict between the legislation of provisions dealing with unpaid present entitlements and the position set out in Draft Ruling TR 2009/D8.

This is because, contrary to the premise of the question, under Draft Ruling TR 2009/D8 unpaid present entitlements will retain that status for Division 7A purposes in many situations, including where:

- the amount representing the UPE is physically held on sub-trust for the sole benefit of the private company beneficiary;
- the amount representing the UPE is being used by the trustee but all benefits from this use are held for the sole benefit of the private company; or
- the private company beneficiary is not aware and cannot be taken to be aware that the funds representing its UPE are being used for the potential benefit of any or all discretionary objects of the trust (rather than being physically set aside or used for its sole benefit).

The ATO has appropriately consulted with Treasury prior to and during the drafting of TR 2009/D8.

Provisions within Division 7A dealing with unpaid present entitlements will continue to have their intended application and there is no inconsistency between the Exposure Draft legislation and the draft Ruling.

Use of assets

5.7 As was announced in the 2009/10 Federal Budget the use of assets owned by private companies, or owned by trusts where there is a present entitlement owing to a private company may be subject to tax after 1 July 2009.

5.8 The way in which the use of assets will become subject to tax is through the amendment of the definition of the term 'payment' in Division 7A so that it extends to the provision of an asset (other than a transfer of property) for use by an entity. Consistent with the present operation of Division 7A the provision of the asset will only result in Division 7A consequences where the asset is provided to a shareholder or associate of a shareholder.

5.9 For the purposes of Division 7A the payment will occur when the use of the asset occurs.

5.10 A payment will also arise however where the asset is not used, but is available for use. The examples in the EM are illustrative of when it will be the right to use the asset, and not its use, that is subject to the Division 7A rules.

> ***Example (right to use from EM)***
> ***Brian is a shareholder of a private company that owns a luxury yacht. He does not have a formal agreement with the company in relation to the yacht, however, he takes the yacht out every second weekend.***
>
> ***Brian keeps the yacht at the company's business premises, but takes the key home. Brian stores several personal items on the yacht.***
>
> ***Brian's fortnightly use of the yacht is a payment under Division 7A. The availability of the yacht for Brian's use is also subject to Division 7A because the yacht is not readily available for use by the company. The company would need to arrange with Brian to***

get the key and for the removal of Brian's personal items before using the yacht. That is, the asset is available for Brian's use to the exclusion of the company.

Example (use from EM)
Marina is a shareholder of a private company that owns a city apartment. The apartment is generally available for rent. However, Marina asks the company not to rent the apartment out for a week so that she and her family can use the apartment over a long weekend. Marina's use of the apartment is a payment for the purposes of section 109CA.

5.11 An issue that arose on consultation over the draft legislation giving effect to these changes was whether the mere availability of assets to a shareholder or associate would result in the shareholder or associate being treated as having the asset available for their use. The EM again includes an example where there a payment is not taken to arise where an asset is available as a result of a general entitlement to use an asset without actual use of the asset.

Example (mere entitlement from EM)
Peter is a shareholder of a private company that owns five cars for company use. Shareholders and their associates have general permission to use the cars on weekends if they are not being used for company business. Peter regularly takes one of the cars home.

Peter's use of the car that he takes home will be subject to Division 7A. This will include driving the car (actual use) and the availability of the car for his use to the exclusion of the company, such as when it is parked at home, or at a restaurant that Peter is visiting.

Although Peter may have general permission to use all five of the cars, he does not use all of them for the purposes of Division 7A. The four cars that Peter leaves at the company premises are available for the company to loan to another shareholder, employee, customer, or other party. That is, these cars are not available to Peter to the exclusion of the company.

5.12 The EM also includes examples of where an asset is available to more than one shareholder or associate and it is necessary to determine who is taxed. The EM suggests and apportionment of the taxable value to the person who is the real recipient of the benefit. One example sets out that a minor that benefits should not be taken to receive a Division 7A payment, where another sets out that incidental use by a spouse of a vehicle provided to a shareholder would not result in the spouse being taxed on the benefit provided.

5.13 In valuing the payment taken to be made it will be the amount that would have been paid for the use of the asset in an arm's length dealing less any consideration paid that will be determined to be the payment for Division 7A purposes.

5.14 There are a number of exceptions from the payment provisions applying, including one not previously announced dealing with residential property:

5.14.1 Minor benefits – if the provision of the asset would have been a minor benefit under section 58P of the FBTAA had it been provided to an employee then the benefit will be disregarded for Division 7A purposes

5.14.2 Otherwise deductible payments – if a once off deduction would have been available to the shareholder or their associate in connection with the use of the asset then there will be no benefit to be taken into account for Division 7A purposes.

5.14.3 Dwellings – the use of a dwelling can be exempt where the following conditions are satisfied:

5.14.3.1 the entity or their associate is carrying on a business;

5.14.3.2 the entity or their associate uses or is granted or has a lease, licence or other right to use land, water or a building for the purpose of carrying on the business; and

5.14.3.3 the provision of the dwelling to the entity is connected with that use or with that lease, licence or other right to use the land, water or building to carry on the business.

5.14.4 Main residences – the provision of a dwelling that is a person's main residence does not result in a Division 7A payment where:

5.14.4.1 The provider of the dwelling is a private company;

5.14.4.2 The private company acquired the dwelling before 1 July 2009; and

5.14.4.3 The private company would pass COT from the time that the dwelling was acquired until the end of the time that a payment could be taken to be made under Division 7A.

5.14.5 Vacant land – if the exception for a dwelling or a main residence applies, it will extend to adjacent land in the same way as occurs in the main residence exemption.

Corporate limited partnerships

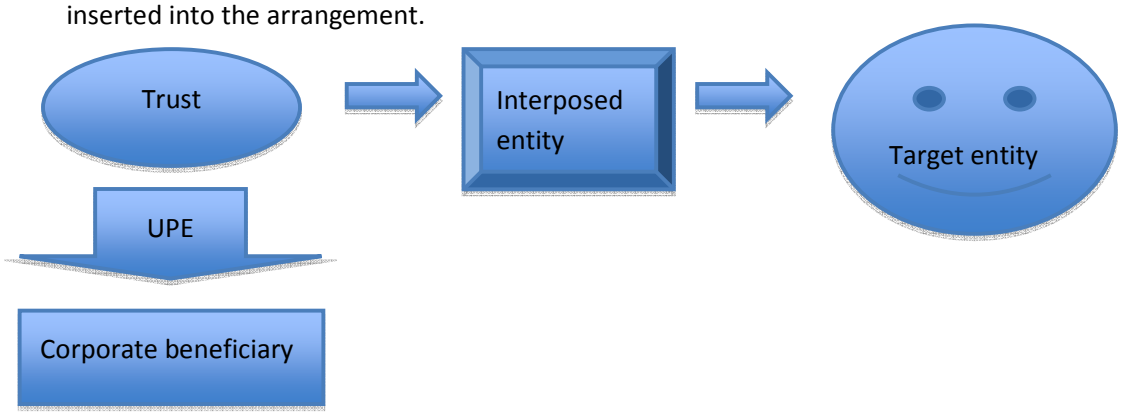
5.15 Closely held corporate limited partnerships (limited liability partnerships) will also now be subject to Division 7A. A corporate limited partnership will be closely held where it has fewer than 50 members or where an entity has, directly or indirectly, for the entity's own benefit, an entitlement to 75% or more of the income and capital of the partnership.

Interposed entities

5.16 The Div 7A Amendments fix two drafting issues in relation to the use of interposed entities.

5.17 The Division 7A legislation as originally drafted allowed for a payment by a private company through an interposed entity to be treated as a payment for Division 7A purposes.

5.18 The legislation did not however on a plain reading, allow for a trust where there was an unpaid present entitlement, to be deemed to have made a payment where an interposed entity was inserted into the arrangement.



5.19 A payment from the trust through an interposed entity to a target entity will now be caught by Division 7A if a reasonable person would consider that a loan or payment made to the interposed entity was made to enable a loan or payment to be made by the interposed entity to the target entity.

5.20 Consistent with the current operation of Subdivision EA however, a payment through to the target entity will only result in a Division 7A deemed dividend if it is referable to a reduction in a present entitlement that is in itself attributable to an unrealised gain in the trust.

5.21 The Div 7A Amendments also ensures that where an unpaid present entitlement is owed to a company by a trust, but the loan, payment or forgiveness that occurs does not involve the trust that owes the unpaid present entitlement, that Subdivision EA still has effect.

5.22 Subdivision EA will apply to treat a loan or payment from a trust as being a Division 7A loan or payment to the extent that the loan or payment is referable to an unpaid present entitlement owed to a private company where that amount has not already resulted in a Division 7A loan or payment.

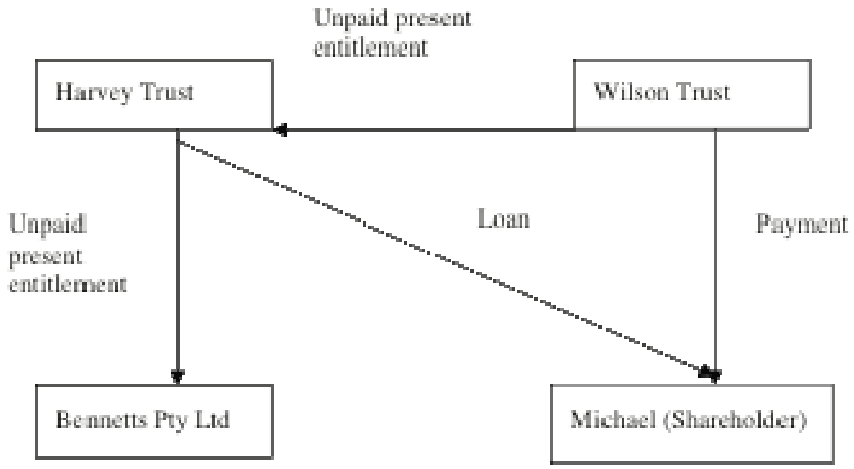
Example (interposed trust from EM)
Michael is a shareholder of Bennetts Pty Ltd and Bennetts Pty Ltd is a beneficiary of Harvey Trust. In the 2009-10 income year, Michael receives a payment from the trustee of the Wilson Trust, which is attributable to an unrealised gain. He receives this payment

because of his shareholding in Bennetts Pty Ltd. Michael also receives a $2,000 non-compliant Division 7A loan from the Harvey Trust.

Bennetts Pty Ltd is not presently entitled to an amount from the net income of the Wilson Trust. However, Bennetts Pty Ltd is entitled to $10,000 from the net income of the Harvey Trust (the first interposed trust) and Harvey Trust is presently entitled to $10,000 from the net income of the Wilson Trust. These amounts remain unpaid.

The loan made by the Harvey Trust to Michael will be included in Michael's assessable income under ordinary operation of subsection 109XA(2).

Bennetts Pty Ltd is taken to be presently entitled to $8,000 from the Wilson Trust, which is the unpaid present entitlement of $10,000 from the Harvey Trust, reduced by the $2,000 loan amount that is included in Michael's assessable income under another provision of Subdivision EA.



Loan back arrangements

5.23 Subdivision EA as currently drafted only captures payment arrangements where the payment is a reduction of a present entitlement that is referrable to an unrealised gain.

5.24 To circumvent these rules, apparently it had been suggested that the following arrangement could be entered into:

5.24.1 An unpaid present entitlement exists to a private company, say of $100,000.

5.24.2 A payment is made by the trustee of the trust to a beneficiary of an amount far in excess of the UPE, for example $1 million.

5.24.3 The amount in excess of the UPE is then loaned back to the trustee, being $900,000.

5.24.4 Thus, the beneficiary now has a credit loan of $900,000.

5.24.5 In future years the trustee appoints income to the company and uses the funds to repay the credit loan.

5.25 The need for there to be a payment referrable to a reduction of an unrealised gain will be removed where the payment made to a beneficiary is in reduction of a loan made on or after 1 July 2009 where a reasonable person would conclude that the trustee obtained the loan in order to make the payment.

Amendment to distributable surplus definition

5.26 The definition of distributable surplus will be amended so that amounts that have been deemed to be dividends as a result of the operation of Subdivision EA will be removed from the distributable surplus (by being correctly included as non-commercial loans).

Forgiveness of 109XB loans

5.27 There is a drafting problem that will be rectified so that the forgiveness of a loan by a trustee that has already been deemed to be a dividend will not result in a subsequent dividend. The law already applies in this way to the forgiveness of a debt owed to a private company by a shareholder that has already been deemed to receive a dividend under Division 7A.

Dividend set-off

5.28 Another drafting problem dealing with dividend set-offs will also be rectified.

5.29 At present, where a private company makes a loan that is deemed to be a dividend and later pays an unfranked dividend that is set off against that loan the later dividend is not included in assessable income.

5.30 The ability to disregard the later dividend does not apply where the loan was made by the trustee of a trust and where the deemed dividend arose under section 109XB.

5.31 The ability to disregard a later unfranked dividend offset against a loan from a trustee is being introduced.

Setting off employment entitlements

5.32 Another unusual aspect of the interaction of Division 7A generally and Subdivision EA has been that employment related payments that are offset against loans by trustees do not count as repayments if there is a borrowing of a similar or greater amount to the amount repaid. This is in contrast to setting off such a payment against a loan by a company where the repayment is taken into account even if there is a further borrowing.

5.33 This anomaly is to be rectified.

Borrowing to repay

5.34 Under the previous law a repayment is disregarded where the repayment is made where a reasonable person would conclude the repayment was made in order to borrow a similar or greater amount. This prevents a person from borrowing funds during a financial year, repaying on 30 June, and then reborrowing the amount on 1 July.

5.35 While the law has operated in this way (with some exceptions for repayments that occur by way of offsetting assessable amounts such as the wages noted above) it arguably has not operated where, instead of repaying to borrow, a person borrows to repay. This was be remedied so that a borrowing to repay will also activate section 109R.

> ***Example (from EM)***
> ***Alicia obtains a loan of $10,000 from Cleary Pty Ltd. Alicia has until the lodgment day to repay the loan. Two weeks before the lodgment day Alicia obtains a further $10,000 from Cleary Pty Ltd. She then repays the original $10,000 loan a week before the lodgment day.***
>
> ***The repayment of the original $10,000 loan is not a repayment for the purposes of section 109D, because Alicia has borrowed a similar amount from Cleary Pty Ltd and in this case a reasonable person would conclude that the loan was obtained in order to make the repayment of the original $10,000.***
>
> ***The original $10,000 loan is treated as a deemed dividend subject to the distributable surplus of the private company.***

Adding back payments for Division 7A purposes

6. Streaming

6.1 The paper will no consider the importance of, and ability to, stream as it stood before the Streaming Amendments. Then it will consider the Streaming Amendments.

Pre-Streaming Amendments

6.2 As can be seen from the illustrations above the ability to stream income according to its character is very important. This is particularly the case for franked dividends and capital gains but there are other forms of income with tax characteristics that may also be important e.g. income from a foreign source, income which has been subject to TFN withholding tax.

6.3 The decisions in Bamford tell us nothing about streaming income for tax purposes.

6.4 Most modern trust deeds will give the trustee power to distinguish between classes of income and to characterise a particular amount of income as having been derived from a particular source. The Deed should also allow the trustee to allocate expenses to the different classes of income.

6.5 The law regarding streaming after the decision in *CPT Custodian Pty Ltd v Commissioner of State Revenue [2005] HCA 53* ("**CPT Custodian**") was quite uncertain. The decision of the High Court in *Charles v C of T [1954] HCA 16* ("**Charles**") has always been the centre of gravity of the character flow through approach. The decision in Charles was heavily criticised by the Court in CPT Custodian. The question is whether that criticism went to the maintenance of character or is restricted to the characterisation of the interest in the trust fund by looking through to the underlying assets.

6.6 The decision of the High Court in CPT Custodian, in the writers' views, stands for the proposition that a beneficiary has an equitable interest in the residue of the trust fund after the Trustee's indemnity has been satisfied. This residue is characterless, whether it be income or capital, as the trustee may at any time satisfy its right to be indemnified from the receipts (which themselves have character).

6.7 Notwithstanding these problems the ATO has consistently taken the view that the character of the income in the hands of the beneficiary is taken from the character of the receipts of the Trustee[4] even after taking into account the decision in *CPT Custodian*[5].

6.8 In the non-binding ruling IT2328 (now withdrawn) it was observed:

> *"For income tax purposes where a beneficiary in a trust estate is presently entitled to the net income or a share of the net income of the trust estate, that income as a general principle has the same character in the hands of the beneficiary as it had in the hands of the trustee."*

6.9 The most significant streaming issues concern capital gains and dividends. In the case of capital gains Division 115 of Part 3-1 of the 1997 Act proceeds on an implication that income entitlements will take on at least some part of the character of the capital gains derived by the trustee. There is no clear legislative follow through. The guidance found in Sesction 115-200 of the 1997 Act establishes the implied maintenance of character:

> *"This Subdivision sets out rules for dealing with the net income of a trust that has a net capital gain. The rules treat parts of the net income attributable to the trust's net capital gain as capital gains made by the beneficiary entitled to those parts."*

[4] see in particular ATO ID 2008/51 dealing with Division 13.3A of the SIS Regulations.

[5] see Taxation Ruling STR 92/13, IT2328, IT2512, IT2004 (withdrawn) and ATO ID 2007/108 (which is concerned with foreign sourced income and in respect of which subsection 6B(2A) of the 1936 Act also comes into consideration).

6.10 Subsection 115-215(1) is the nub of the provisions:

> *"The purpose of this section is to ensure that appropriate amounts of the trust estate's net income attributable to the trust estate's capital gains are treated as a beneficiary's capital gains when assessing the beneficiary, so:*
>
> *(a) the beneficiary can apply capital losses against gains; and*
>
> *(b) the beneficiary can apply the appropriate discount percentage (if any) to gains."*

6.11 The process is described as attribution rather than maintenance of source character. This may be the necessary distinction to make the rules work. There is, however, no guidance about how the attribution is to be carried out.

6.12 What is clear is that if there is no trust income to which the beneficiary is presently entitled there can be no attribution. This is a major issue where there is no trading income but there are capital gains in the Trust. Use of s 95(1) terms to describe income overcomes this problem and makes the case for attribution much clearer. The capital gain (or at least 50% of it) will be included in the income. The connection for Subdivision 115-C purposes is very clear.

6.13 The ATO has had to resort to the artificiality of the "capital beneficiary approach" in PS LA 2005/1 (GA) to achieve this sensible outcome – but this practice statement was withdrawn following Bamford.

6.14 The issues with streaming can be readily appreciated in the context of capital gains and the 50% general CGT discount. The streaming issue is, of course, the denial of the 50% CGT general discount when a trust to company distribution is in play.

6.15 Maintaining the example used above in which there is a net capital gain of $100,000, and gross rental income of $50,0000 and net rental income of $20,000.

6.16 In this instance the trustee wishes to cause the capital gain to be assessed in the hands of an individual (say Mrs A) and the net rental income in the hands of a company, A Co. If it is assumed that the Trust Deed has all of the usual income characterisation and streaming provisions and the Deed adopts subsection 95(1) terms, the outcome readily appears.

6.17 The income entitlements are:

	$	
A Co	20,000	comprising net rental income
Mrs A	50,000	comprising the capital gain
	70,000	

6.18 If the ATO took the view that streaming was unobtainable the outcome would be:

	$	$ Total
A Co	5,714 + taxable capital gain $28,572	34,286
Mrs A	50,000	50,000
		84,286

6.19 The other area of concern is franking credits. At least there is a ruling on this aspect of streaming, *Taxation Ruling* 92/13 (repealed as of 22 June 2011 because of the Streaming Amendments). The provisions of Subdivision 207-B and in particular ss 207-45 to 207-57 are consistent with flow through of the franked character of a dividend.

6.20 The fact the Example set out immediately below s 207-35(3) of the 1997 Act depends on character maintenance. It is worthwhile setting this Example out in full:

> *"A franked distribution of $70 is made to the trustee of a trust in an income year. The trust also has $100 of assessable income from other sources. Under subsection (1) the trust's assessable income includes an additional amount of $30 (which is the franking credit on the distribution). The trust has a net income of $200 for that income year.*
>
> *There are 2 beneficiaries of the trust, P and Q, who are presently entitled to the trust's income. Under the trust deed, P is entitled to all of the franked distribution and Q is entitled to all other income.*
>
> *The distribution flows indirectly to P (as P is entitled to a share of that net income and has a 100% share of the distribution under section 207-55). P therefore has an amount of assessable income that is equal to its share of the distribution. Under this subsection, P's assessable income also includes the full amount of the franking credit (as P's share of the franking credit on the distribution is $30 under section 207-57). Q's share of the net income therefore does not include any of the franking credit."*

6.21 Clearly the legislation contemplates maintenance of character for the purposes of dividend imputation.

Commissioner's Concern of Division 6 Abuses

6.22 As usual the ATO is driven by the possibility that the decision in Bamford might support some abuse and revenue loss. No matter that their interpretations lead to massive headaches for practitioners.

6.23 This much is exampled by several examples set out *in Practice Statement PS LA 2009/7* which was released prior to the decision in Bamford.

6.24 Examples 1 and 5 in particular show what the ATO is on about.

6.25 Example 1 concerns the trustee of a family trust deriving $250,000 in income during the income year and applying that income to the purchase of a holiday home. The trustee, acting in accordance with a power expressed in the terms of the Trust Deed to do so, determines that the expenditure on the purchase of the house is an outgoing on income account with the effect that the trust law income available for distribution is $5,000. One of the beneficiaries has tax losses.

6.26 The trustee distributes the $5,000 trust law income to the loss beneficiary. The losses cover the tax law income which follows the trust law income to the loss beneficiary.

6.27 The ATO expresses concern about the mismatch of the actual amount to which the beneficiary becomes entitled ($5,000) and the amount of the tax law income flowing to the beneficiary ($250,000) and the tax not paid because of the losses.

6.28 It is difficult to say why this is of concern to them. The true effect of the transaction is to maintain $245,000 in the capital of the trust. The same tax effect would be obtained by distributing all of the $250,000 to the loss beneficiary. There is no tax difference in this illustration. It is unlikely there would be a tax benefit for the purposes of Part IVA. The most likely explanation for the transaction is the financial risk the loss beneficiary has been exposed to. If the beneficiary became entitled to call on the trustee to pay him or her $250,000 the creditors may be able to stake a claim to that amount. It is a neat and sensible piece of asset protection planning.

6.29 Example 5 is about a trust which has distinct income and capital beneficiaries. The trustee has a power to determine whether receipts and outgoings are on income or capital account. The Trust Deed is amended to admit a tax exempt entity as a beneficiary.

6.30 The trust derives $100,000 of income (meaning income according to ordinary concepts) during the income year. The trustee determines that $95,000 of that amount is a capital receipt. The remaining $5,000 is the trust law income according to the Trust Deed. This amount is appointed to the tax exempt beneficiary. All of the tax law income will be assessed to the charity. It would follow that the trustee makes a capital distribution of the $95,000 to a family beneficiary.

6.31 The ATO observe in the Practice Statement that Part IVA might apply in the circumstances. In the writer's view it almost certainly would do so in particular because of the amendment to introduce the tax exempt charity as a beneficiary and the fact that prior year distributions had been made only to family members. A much more challenging (and perhaps more realistic) illustration would arise if the tax exempt charity was already an object and the trustee had made distributions to charities in the past. The Part IVA case in such circumstances would be difficult to make out. This is an example of the acknowledged "apparent unfairness in the resulting administration of the legislation" as noted by the High Court in Bamford at [17].

6.32 The ATO apparently accept that Bamford authorizes characterization of capital receipts as income for the purposes of the Deed but are not so ready to accept that ordinary income may be recharacterised as capital (as in Example 5). They appear to be fortified in this by observations made by the Full Court of the Federal Court in *Forrest v C of T* [2010] FCAFC 6 ("**Forrest**").

6.33 The relevant question before the Court there was whether Mr Forrest was entitled to a deduction for interest he had incurred in relation to funds he had borrowed to acquire units in a unit trust. The outcome turned on whether there was a fixed income component to which the funds related. The Full Court concluded that a power to determine whether any amount received by the trustee was on revenue account or capital account (clause 12 of the Deed) was not a power to change the beneficiaries' rights. In so doing they observed at [11]-[12]:

> *'In our opinion, the power conferred by cl. 12 cannot be exercised by the trustee wrongly to classify a receipt as a capital gain, when the receipt is, in truth, income, and thus deprive the appellant of his interest in the unit component of the trust. Clause 12 is not an unlimited power to be exercised in the trustee's unconfined discretion….*
>
> *Clause 12.2(a) is a power to determine how a distribution to beneficiaries is classified. That limited power is not a power which is capable of altering the beneficiaries' rights. Clause 12 is to be read consistently with the balance of the Trust Deed and an appreciation that it contains various powers of an administrative character. The words used can be given full force honestly to classify income or distributions according to law, as the appellant contended to this Court".*

6.34 It is very difficult to know how far this goes. The issue in Forrest was about whether or not the exercise of the power changed the rights as between classes of beneficiaries. Presumably the ATO would say that the exercise of the power in a case like that in Example 5 was not an "honest" classification of the receipt as capital. Hopefully the issue will not arise very often.

Point of Interest

6.35 A case of interest is *Greenhatch v FCT* [2011] AATA 479 that ostensibly concerned superannuation contributions where the answer to the superannuation question was determined by construing streaming through a trust. The case of is interest for two reasons.

6.36 First, the AAT went out of their way to note the Commissioner's interpretation of Bamford was wrong. At [49] and [50] they said:

> *Much, if not all, of the Commissioner's case turns on his rejection of any underlying conduit theory and his interpretation of the implications of the decision in Bamford.*

The Commissioner's contention that the conduit theory has no role to play is based on foundations with which we do not agree. Accordingly, those foundations do not support the conclusion he seeks to draw.

6.37 Secondly, in relation to Subdivision 207-B of the 1997 Act, being the franking credits provisions, the AAT observed at [63]:

> *Section 207-35 of the 1997 Act has an aspect that makes the conclusion [that] amounts passing through trusts to beneficiaries thereof carry the character and identity that they had in the hands of the trustee more compelling. That section includes an example that contemplates differential distributions in determining the taxation burdens that are imposed on the beneficiaries of the trust.*

6.38 Question: was it necessary to introduce the Streaming Amendments in light of the above comments? Given we have the Streaming Amendments it is of academic interest only.

Streaming Amendments

6.39 The *Tax Laws Amendment (2011 Measures No. 5) Act* 2011 (Cth) was introduced into parliament (as a Bill) on 2 June 2011, was passed unamended and assented to on 29 June 2011. They take effect from 1 July 2010. These dates show how close a call it was as the Streaming Amendments are critical for trustee decisions that were needed to be made on 30 June 2011 – one day after their royal assent.

6.40 Subject to a statement by the Commissioner – extending the time a trustee could make decisions to 31 August 2011, which has anyway passed, but the writers question the Commissioner's ability to alter what trust law[6] requires to be done on 30 June of any year – the Streaming Amendments apply to trustees resolving to deal with trust income and capital gains.

6.41 From the 2011 income year and thereafter taxable capital gains and franked distributions are dealt with under these rules.

6.42 The Streaming Amendments operate by diverting from Division 6 of the 1936 Act the franked distributions and taxable capital gains. They are assessed directly in the hands of the beneficiaries who are presently entitled to them. They do this via Subdivision 207-B of the 1997 Act for franked distributions and via Subdivision 115-C of the 1997 Act for taxable capital gains. However, for the taxable capital gains they must still pass through the method statement in s 102-5(1) of the 1997 Act.

[6] *Trustees of the Estate Mortgage Fighting Fund Trust v FCT* [2000] FCA 981 per Hill J; *Case R105,* 84 ATC 692; *Antonopoulos v FCT* [2011] AATA 431.

6.43 The Streaming Amendments have introduced a new Division 6E into Part III of the 1936 Act to prevent double taxation. It adjusts the Division 6 income and net income of the trust to take out the amounts to which the beneficiary has been made specifically entitled.

6.44 It can be seen that the specific entitlement of the beneficiary or beneficiaries is the critical aspect of the Streaming Amendments. This is required to determine tax liability.

Specific Entitlement

6.45 The notion of a specific entitlement conceals the difficulties of applying the Streaming Amendments to all trusts, be they discretionary, fixed, unit, et cetera. The mechanism by which you become specifically entitled are set out in the relevant Subdivisions: s 115-228 for capital gains and s 207-58 for franked distributions. The provisions seem substantially similar at first look but there are some significant differences.

6.46 A beneficiary is specifically entitled under s 207-58 of the 1997 Act to an amount of a franked distribution made by the trust equal to the amount calculated under the following formula

$$\text{Franked Distribution} \times \frac{\text{Share of net financial benefit}}{\text{Net financial benefit}}$$

6.47 The "net financial benefit" is an amount equal to the financial benefit referable to the franked distribution (after an application by the trustee of expenses that are directly relevant to the franked distribution).

6.48 The term "financial benefit" is already in s 995-1 f the 1997 Act. It means anything of economic value, even if the transaction also imposes an obligation on the entity. Benefits and obligations are to be looked at separately and not set off against each other, but it is the net financial benefit to which the formula looks.

6.49 The "share of the financial benefit" is the amount of the financial benefit referable to the franked distribution specifically linked to the particular beneficiary. The share of the net financial benefit is:

> *… an amount equal to the *financial benefit that, in accordance with the terms of the trust:*
>
> *a. the beneficiary has received, or can be reasonably expected to receive, and*
>
> *b. is referable to the *franked distribution (after application by the trustee of any expenses that are directly relevant to the franked distribution) and*
>
> *c. is recorded, in its character as referable to the franked distribution, in the accounts or records of the trust no later than the end of the income year.*

6.50 Section 115-228 is identical to the discussion above of franked distributions, subject to:

6.50.1 the financial benefit must be referable to the capital gain "after application by the trustee of any losses, to the extent that the application is consistent with the application of capital losses against the capital gain in accordance with the method statement in subsection 102-5(1)"; and

6.50.2 the recording of the financial benefit must be "no later than 2 months after the end of the income year."

Complexities and Going Forward

6.51 An issue to be mindful of is – in fact an issue of significant importance – is that a trust with no "income", which was one of the problems in the Bamford appeals, will not be able to stream franking credits. This will mean that where the franked distributions, together with other ordinary income, is insufficient to more than offset expenses of the trust the franking credits cannot go through to the beneficiaries. The same restriction does not apply in relation to capital gains streamed through the trust.

6.52 Ken Schurgott FTIA, in his paper in the August 2011 *Taxation in Australia* titled "Trust streaming 2011" notes a number of complications that arise from the Streaming Amendments:

> *As will be seen, there are a number of issues which emerge that complicate the legislation over and beyond the rather simple approach adopted prior to the Commissioner's stance on streaming. The things which complicate matters are:*
>
> *a. There can be different outcomes according to the definition of income adopted by the trust deed;*
>
> *b. Significantly different outcomes can result where a beneficiary has not been made specifically entitled to the franked distribution or capital gain. This is most pronounced in relation to capital gains;*
>
> *c. The concept of making a beneficiary entitled to the entire financial benefit from a capital gain or franked distribution is fraught with difficulty, particularly where there are capital losses or directly related expenses; and*
>
> *d. The way in which capital losses and directly related expenses are to be dealt with is confusing.*

6.53 It can be seen from these further issues, and the problem of actually apply what is a simple concept of diverting the amounts to Subdivisions 115-C and 207-B respectively, are anything but straightforward or settled. Indeed, a senior council on the writer's floor, after having advised on

the Streaming Amendments is of the view that this is where future archeologists will find the bones of 21st Century tax lawyers and accountants.

7. Changes to the taxation of trusts – terms to be provided for in a trust document

7.1 Given the changes in the taxation of trusts, it is recommended that trust deed (or any other constituent documents) be reviewed so as to determine:

7.1.1 How income, capital gains and outgoings are accounted for and determined; and

7.1.2 How income, capital gains and outgoings are to be distributed.

7.2 Some of the powers which may be advantageous to have within a trust instrument include:

7.2.1 an accounting policy which is sufficiently broad and allows the trustee to exercise maximum discretion;

7.2.2 the discretion to reclassify and allocate income and capital gains;

7.2.3 the discretion to reclassify and allocate outgoings;

7.2.4 the discretion not to recoup losses (whether income or capital in nature);

7.2.5 the ability to allocate and stream classes of income and capital and their related tax attributes;

7.2.6 and ensure that any unpaid present entitlement / loan provisions are removed, and an ability to hold amounts subject to a sub-trust.

7.3 Some additional powers to be considered include:

7.3.1 whether the trustee has the power to distribute income and / or capital at any time within a tax year;

7.3.2 whether any determination of income (or capital) can be made within the income tax year; and

7.3.3 whether the trustee has a power to determine entitlements with respect to an income tax year after the relevant year.

Accounting policy

7.4 Essential is ensuring that the trust deed provides guidance with respect to an accounting policy that should be used by the trustee. Such an accounting policy should provide sufficient flexibility for the trustee, so that it may depart from generally accepted accounting standards in the event that the trustee considers that it is appropriate to do so.

Reclassifying and allocating income and capital

7.5 As the High Court in *Bamford* accepted that the tax law income of a trust is dependent upon (amongst other things) the definition of that term in the trust deed, regard should be given to the definition of the 'income' as contained in the trusts constituent documents.

7.6 An issue to consider is whether attributed amounts (e.g. franking credits) should be included within the definition of trust income. An issue that arises is that if attributions are included in trust income (and which are not physically 'paid' by a trustee – but which follow certain amounts of income), whether by being included in trust income, and thereby providing that a trustee creates a 'present entitlement' in a beneficiary to an amount that is never received by a trustee, the trustee will be exposed to a claim in relation to amounts that are not actually received by the trustee.

7.7 It is submitted that amounts such as franking credits should be prima facie carved-out of the definition of income. However, the definition should contain discretionary elements to allow a trustee to cause such 'attributed' amounts to fall within the definition of income.

7.8 An approach which may be considered is, in defining trust income:

7.8.1 Provide that it prima facie equals the amount provided for in s 95(1) of the 1936 Act (less any franking credits);

7.8.2 If the tax law approach is not warranted for a particular tax period, then:

7.8.2.1 According to an accounting policy adopted by the trustee; or

7.8.2.2 Any other basis as determined by the trustee; or

7.8.3 In the trustee's absolute discretion, the gross income of the trust.

Reclassifying and allocating outgoings

7.9 In *Cajkusic v FC of T (No 2)* (2006) ATC 4752 ("**Cajkusic**") deductions allowable to a family discretionary trust for payments that were made under an employee benefits trust arrangement in the income tax years ending 30 June 1997 and 30 June 2008 caused there to be a loss within the trust estate.

7.10 As a result of the losses, there was no distributable income of the trust. As a result, the Full Court of the Federal Court held that the lack of distributable income meant that there could be no beneficiary of the trust (for the relevant income tax years) to be "*… presently entitled …*'"pursuant to s 97 of the 1936 Act to any amount.

7.11 It should be noted that the Commissioner's subsequent application for special leave to appeal to the High Court was rejected.

7.12 Cajkusic stands for the proposition that the 'distributable income' of a trust is determined by reference to proper accounting principles, as well as the terms of a trust deed. In this context distributable income is income determined according to accounting principles, and which is distributable amongst the beneficiaries. It does not alter either the income as calculated under accounting principles, of the 'net income' as determined under s 95(1) of the 1936 Act – rather, only gives a trustee the power to determine the distributable amounts.

7.13 As a result of the decision in Cajkusic, it is submitted that a trust deed should give a trustee the power to reclassify, and allocate outgoings, so that there can be 'distributable income' to which beneficiaries are presently entitled.

Discretion not to recoup losses (whether income or capital in nature)

7.14 It is recommended that a trustee have a discretion not to recoup losses (whether of an income or capital nature). That is, a power not to recoup losses which have arisen in the past.

8. Resettlement considerations

8.1 Whenever the terms of a trust are varied, an issue to consider is whether the variation amounts to a 'resettlement'.

8.2 Resettlements relate to changes to a trust relationship which have the effect that a new trust estate comes into existence. According to the High Court in *FC of T v Commercial Nominees of Australia Ltd* [2001] HCA 33 (***"*Commercial Nominees"**), the issue to determine is whether '*… what occurred* … [i.e. the variation] … *was a fundamental alteration in the trust relationship*

established by the original deed, such that it destroyed the necessary continuity of the 'taxpayer'…'.

8.3 A resettlement can have significant income tax, capital gains tax (**'CGT'**) and stamp duty consequences, including that:

8.3.1 the trust property may be disposed of, potentially triggering both stamp duty and CGT liabilities;

8.3.2 carried forward tax benefits may be lost; and

8.3.3 beneficiaries may dispose of their interests in the original trust and acquire interest in a new trust.

8.4 Specifically in the context of CGT, a resettlement may cause either CGT event E1 (s 104-60 of the 1997 Act) or CGT event E2 (s 104-65 of the 1997 Act) to happen.

8.5 In August 2001 the issued a Statement of Principles entitled *Creation of a new trust* (the **"Statement**"). The Statement clarifies when, in the Commissioner's view, changes to a trust gives rise to a new trust. The Commissioner considers that a new trust estate arises where there is a 'fundamental change to a trust relationship' – ie, a change in the essential nature and character of the original trust relationship. Further, the Commissioner considers that a new trust (i.e. a resettlement) may arise in the following circumstances:

- a change in beneficial interest in trust property;
- a new class of beneficial interest (whether introduced or altered);
- a redefinition of the beneficiary class;
- changes in the terms of the trust or the rights or obligations of the trustee;
- changes in the nature of the trust property;
- additions of property which could amount to a new and separate settlement;
- depletion of trust property;
- a change in the termination date of the trust;
- a change in the trust that is not contemplated by the terms of the original trust;

- a change in the essential nature and purpose of the trust; and / or
- a merger of two or more trusts or a splitting of the trust.

8.6 The Commissioner considers that depending on their nature and extent, the above changes may either amount to:

8.6.1 a variation of a continuing trust; or

8.6.2 a fundamental change in the essential nature and character of the trust relationship. In such a case, the original trust may be brought to an end and a new trust created. Whether a new trust is created depends on the terms of the original trust and on the powers of the trustee.

8.7 The High Court in Commercial Nominees held that significant changes to a superannuation fund trust deed did not create a new trust, even though the amending deed had:

8.7.1 changed the name of, and appointed a new trustee to the fund;

8.7.2 introduced a new category of beneficiaries;

8.7.3 changed the fund from a defined benefit fund to an accumulation fund;

8.7.4 appointed a professional management company as administrator; and

8.7.5 allowed membership to be promoted to the public.

8.8 The High Court in *Commercial Nominees* considered that there were three main indicators of the continuity of a trust relationship, being:

8.8.1 the constitution of the trust;

8.8.2 the trust property; and

8.8.3 the membership of the trust.

8.9 Substantial changes any of the above may cause a resettlement.

8.10 The High Court considered that, in order to destroy the necessary continuity, changes in one or more of the above indicators must be such as to terminate the existence of the entity, or to produce the result that the particular trust does not derive the income in question. It was held that the changes made to the trust deed in question were not sufficient to destroy the continuity, primarily because the fund was at all times governed by the same deed, the trust property did not change, and the members before the amendment to the trust deed remained members afterwards. We consider that the amendments discussed above will not cause a resettlement.

8.11 The Commissioner notes in the Statement that administrative changes, such as re-defining trust income (without more) may not cause a resettlement (depending on the context) as it may be administrative in nature.

8.12 However, regard will need to be given to the implications to the membership (i.e. the beneficial entitlements) of the trust, and what implications such an amendment will have on the respective entitlements in a trust. For example, an important consideration will be determining how unallocated / undistributed income is to be dealt with. For example, is such income:

8.12.1 accumulated, and form part of the corpus of the relevant trust estate;

8.12.2 is it distributed to certain default beneficiaries; or

8.12.3 is it held on trust for a specific purpose (e.g. a charitable purpose).

Changes in the Taxation of Trusts

A paper presented by Michael Bennett and Denis Barlin at the NSW Young Lawyers CLE

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Michael Bennett E bennett@sevenwentworth.com.au D 8224 3055 M 0408 029 416
Denis Barlin E dbarlin@wenworthchambers.com.au D 9231 6646 M 0404 848 311

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1. General overview

1.1 The income years ended 30 June 2010 and, more particularly, 30 June 2011 have been very active for the taxation of trusts. Significant events in three areas of trust taxplay activity:

1.1.1 decisions of the Courts and principally the High Court's decision in *Commissioner of Taxation v Bamford* (2010) 240 CLR 481; (2010) 264 ALR 436; [2010] HCA 10 ("**Bamford**");

1.1.2 legislative changes, principally:

1.1.2.1 the new rules set out in *Tax Laws Amendment (2011 Measures No. 5) Act* 2011 (Cth) (the "**Streaming Amendments**") that deal with taxation of franking credits and capital gains in trusts; and

1.1.2.2 the new rules set out in the *Tax Laws Amendment (2010 Measures No. 2) Act* 2010 (Cth) that are principally about Division 7A of Part III of the *Income Tax Assessment Act* 1936 (Cth) (the "**1936 Act**") and companies providing rights to use property, but also contain some trust issues (the "**Div 7A Amendments**"); and

1.1.3 Australian Taxation Office ("**ATO**") activities principally the very controversial draft ruling on unpaid present entitlements, TR 2009/D8.

1.2 Some of these changes have overtaken themselves. For instance, there was at the time – and this paper includes – a discussion of streaming post Bamford (see **heading 4** below). That discussion should be read as having been overtaken by the Streaming Amendments (see **heading 5**).

1.3 And what's more the change is not over. Chapter 2 of the explanatory memorandum to the Bill that introduced the Steaming Amendments makes it clear that the streaming provisions have been introduced as an interim measure to deal with perceived anomalies in the taxation of capital gains and franked distributions pending a comprehensive review of Division 6 of Part II of the 1936 Act.

1.4 The changes made so far give rise to issues themselves and further consequential issues for trusts. In addressing the issues – both outlined above and the consequential issues – this paper will discuss:

1.4.1 Taxation of trusts generally;

1.4.2 The competing views before Bamford;

1.4.3 The context of Bamford and what it means for trusts;

1.4.4 Briefly (as it is not germane to the other issues raised in the paper) what are the Div 7A Amendments and what they mean for trusts;

1.4.5 What are the Steaming Amendments and what they mean for trust;

1.4.6 What a trust deed needs in light of those three issues; and

1.4.7 Amending trust deeds to deal with those three issues.

1.5 The issues are dealt with in this order as they are chronological to their occurring.

2. Taxation of Trusts

2.1 The provisions dealing with the taxation of trust income are contained in Division 6 of Part III of the 1936 Act (which comprises of sections 95 to 102).

2.2 As a result of the enactment of Streaming Amendments, regard should also be given to:

2.2.1 Subdivision 207-B of the *Income Tax Assessment Act* 1997 (Cth) (the "**1997 Act**") – which deals with franking credits obtained by a trust estate; and

2.2.2 Subdivision 115-C of the 1997 Act – which deals with the distribution of capital gains by a trust estate.

2.3 Chief Justice Latham in *Tindal v FC of T* (1946) 72 CLR 608 at 618 observed that the object of Division 6 of the 1936 Act is to "*… secure payment of tax upon the whole of the net income of a trust estate, either from a beneficiary or the trustee, whether the income is paid over to or on account of the beneficiary …*". Further, according to Emmett J in *Bamford v Federal Commissioner of Taxation* (2009) 176 FCR 250 "*… an important assumption underlying Division 6 …* [is] *… that a beneficiary who derives a share of the net income should be in a position to pay out of that income; otherwise, the beneficiary could be placed in a difficult position*."

2.4 The starting point in determining the taxation of trust income is s 97 of the 1936 Act. Relevantly, s 97(1) of the 1936 Act 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; and

(b) the exempt income of the beneficiary shall include:

(i) so much of the individual interest of the beneficiary in the exempt income of the trust estate as is attributable to a period when the beneficiary was a resident; and

(ii) so much of the individual interest of the beneficiary in the exempt 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;

except to the extent to which the exempt income to which that individual interest relates was taken into account in calculating the net income of the trust estate; and

(c) the non-assessable non-exempt income of the beneficiary shall include:

(i) so much of the individual interest of the beneficiary in the non-assessable non-exempt income of the trust estate as is attributable to a period when the beneficiary was a resident; and

(ii) so much of the individual interest of the beneficiary in the non-assessable non-exempt 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]

2.5 That is, s 97 of the 1936 Act provides that where a beneficiary, who is not under a legal disability is presently entitled to a "*… share of the income of the trust estate …*", the assessable income of:

2.5.1 a resident beneficiary includes the beneficiary's share of the '*… net income of the trust estate …*'; and

2.5.2 a non-resident beneficiary includes so much of the beneficiary's share of the net income of the trust as is attributable to sources in Australia.

2.6 It should be noted that the term "net income of the trust estate" for the purposes of s 97 of the 1936 Act is defined in s 95(1) of the 1936 Act. However, the term "*… the income of the trust estate …*" as contained in s 97 of the 1936 Act is not defined in the 1936 Act.

2.7 Subsection 95(1) of the 1936 Act defines the term 'net income', in relation to a trust estate as:

> ***net income**, 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 Division 393 of the Income Tax Assessment Act 1997 (Farm management deposits) 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.*

2.8 For completeness, it should be noted that:

2.8.1 s 98 of the 1936 Act provides that the trustee is liable to tax on behalf of a beneficiary where the beneficiary is presently entitled to a share of the income of a trust estate, but the beneficiary is under a legal disability;

2.8.2 ss 99 and 99A of the 1936 Act apply to subject the trustee to tax where there is some part of the net income of a trust estate that is not subject to tax under either of ss 97 or 98 of the 1936 Act. The difference as between s 99 and s 99A of the 1936 Act is the rate of tax applicable. Typically, the trustee will be subject to tax under section 99A of the 1936 Act at a penal rate of tax equal to the maximum rate of tax (currently 45%). However, the Commissioner has a discretion to apply s 99 of the 1936 Act in certain circumstances, in which case the trustee will be subject to tax at the normal marginal rates of tax.

3. The two competing views before the decision in Bamford

3.1 There has been, for some time, two competing views in the taxation of trust income – the proportionate view and the quantum view.

Proportionate approach

3.2 *David & Anor v FC of T* 89 ATC 4377 contains an example of the application of the proportionate approach (which according to the High Court's decision in Bamford, is the correct approach).

3.3 The proportionate view looks to the share (or proportion) of trust law income of a trust to which a beneficiary is "presently entitled", and then applies that share or proportion to the net income of a trust estate to calculate how much of the net income is to be included in the beneficiary's assessable income.

3.4 As an example, if a beneficiary is entitled to one half of the trust law income, then the beneficiary must include half of the net income in their assessable income – irrespective of whether it is more or less than the amount of the trust law income to which they are entitled.

(a) Implications if tax law income exceeds trust law income

3.5 Under this approach, a beneficiary who is "presently entitled" to trust law income may be required under s 97(1) of the 1936 Act to include in their assessable income an amount of net income which is greater than the amount of trust law income to which they are entitled, and to which has been paid or distributed to them.

3.6 That is, they may be subject to tax on amounts whish they will not receive, and are not entitled to actually receive.

3.7 This outcome seems to be contrary to the objectives of Division 6 of the 1936 Act as outlined by Emmett J in the Full Court of the Federal Court decision in *Bamford v Federal Commissioner of Taxation* (2009) 176 FCR 250 (discussed above).

(b) Implications if trust law income exceeds tax law income

3.8 However, where the net income of a trust estate for the purposes of s 95(1) of the 1936 Act is less than the trust law income, then a beneficiary who is "presently entitled" pursuant to s 97(1) of the 1936 Act will be required to include in their assessable income an amount which is less than the trust law income to which they will be entitled, and which will be paid to them.

3.9 As a result, an on the assumption that the beneficiaries are "presently entitled" to the whole of the trust law income, with the result that the whole of the "net income" of the

trust estate is included in their assessable income pursuant to s 97(1) of the 1936 Act, there can be no part of the net income to which ss 99 or 99A of the 1936 Act applies.

3.10 There is still a question as to whether, in these circumstances, the beneficiary must include the excess amount (i.e. the amount not included under s 97(1) of the 1936 Act) under some provision of the tax acts (e.g. CGT event E4 as contained in s 104-70 of the 1997 Act).

The quantum approach

3.11 The quantum approach (which is no longer good law) is based on the proposition that a beneficiary can only be presently entitled to such amount(s) of trust income as they actually receive.

3.12 Further, any part of the net income of the trust estate which exceeds the amount to which the beneficiary is presently entitled is not income to which the beneficiary is presently entitled to pursuant to s 97 of the 1936 Act, with the result that the trustee is subject to tax on it under s 99A of the 1936 Act (unless the Commissioner exercises it discretion to cause it to be subject to tax under s 99).

3.13 As with the proportionate approach, where the net income of the trust estate for s 95(1) of the 1936 Act purposes is less than the trust law income, such that the beneficiary receives an amount which is greater than the amount included in their assessable income, the question arises as to how the excess is to be taxed (if at all).

4. Bamford

4.1 Bamford was a much anticipated decision. In the view of some[1] the decision was a missed opportunity to settle an area of the trust law and tax law that has been crying out for correction: *Bamford* at [17] citing Hill J in *Davis v Federal Commissioner of Taxation* (1989) 86 ALR 195 at 230.

Background to Bamford

4.2 Mr and Mrs Bamford were beneficiaries of a discretionary trust known as the Bamford Trust (the "**Trust**"). The trustee of the Trust was P&D Bamford Enterprises Pty Ltd. Mr and Mrs Bamford were also the directors and employees of P&D Bamford Enterprises Pty Ltd.

[1] Slater QC *Taxation Trust Income After* Bamfor'ds *Case*, 26th National TIA Convention, 2-4 March 2011

4.3 During the 2000 income tax year, the Trust made a contribution to an offshore superannuation fund on behalf of Mr and Mrs Bamford. The contribution was sourced from borrowings by the corporate trustee, in its capacity as trustee of the Trust.

4.4 For the purposes of determining the "net income" of the Trust for the 2000 income tax year, the corporate trustee (in its capacity as trustee of the Trust) claimed a deduction for both the contribution made to the offshore superannuation fund, and the interest on the borrowed funds used to make the contribution. The total deduction claimed was $191,701.

4.5 After taking into account of the deductions, the "net income" of the Trust for that year was distributed to specified beneficiaries of the Trust. Included in the distribution were Mr and Mrs Bamford, who both had specified amounts distributed to them.

4.6 Specifically, for that income tax year (i.e. the 2000 income tax year), the trustee of the Trust allocated amounts to certain beneficiaries of the Trust, including a payment of $34,000 each to Mr and Mrs Bamford. However, the trustee of the Trust did not have sufficient funds to pay the full amount of $34,000, and instead paid them $33,872, being what the trustee of the Trust thought was the total remaining trust funds.

4.7 The amount initially distributed by the trustee of the Trust was $187,530.

4.8 In 2005, the Commissioner of Taxation applied the anti-avoidance provisions so as to disallow the deductions of the Trust (for the 2000 income tax year) for the superannuation contribution and the interest. As a result of the denial of the deductions, for the purposes of the 2000 income tax year the Trust's taxable income exceeded its accounting income.

4.9 The decision essentially dealt with two things:

4.9.1 whether the 'proportionate approach' applied in the event that tax law income exceeds accounting / trust income; and

4.9.2 whether the trust deed of the trust could characterise an amount of capital gains as income of the Trust.

Application of the proportionate view

4.10 As a result of the denial of the deduction, the Trust's taxable income increased by $191,000. The Commissioner issued amended income tax assessments to both Mr and Mrs Bamford. Pursuant to the assessments, the Commissioner contended that Mr and Mrs Bamford were liable to tax on the increased 'net income' of the Trust based on the proportionate share of the amount by which the taxable income of the trust exceeded the accounting income.

4.11 Indeed, the Commissioner sought to assess Mr and Mrs Bamford on an extra $34,624, on the basis that that amount represented the 'share' of the additional $191,000 as their share (i.e. 18%) of the previous amount (i.e. $187,530) actually distributed.

4.12 However, the taxpayers argued that they should only be taxed on the difference between the $33,872 which they actually received, and the specific amount of $34,000 which was originally allocated to them (i.e. an amount of $128 each).

4.13 The High Court rejected the taxpayer's argument, and in doing so applied the "proportionate approach".

4.14 The High Court took a two step approach in dealing with this issue:

4.14.1 First – the High Court held that the term "*… income of the trust estate …*" as contained in s 97(1) of the 1936 Act refers to distributable income, being income as determined by the trustee taking into account the terms of the trust (e.g. the trust deed) and appropriate accounting principles.

4.14.2 Secondly – after ascertaining the "share" of the distributable income to which a beneficiary is presently entitled, s 97(1) of the 1936 Act then requires that "*… that share of the net income of the trust estate …*" be ascertained, being the shares of the taxable income and not the distributable income.

4.15 Further, it was held that the inclusion within s 97(1) of the 1936 Act of the defined phrase "*… net income of the trust estate …*" and the undefined term "*… the income of …* [the] *… trust estate …*" indicated that these were intended to have different meanings. As a result, the term "*… the income of …* [the] *… trust estate* " had a different and defined meaning for taxation purposes.

4.16 The Court at [45] held that the analysis of Sundberg J in *Zeta Force Pty Ltd v Commissioner of Taxation* (1998) 84 FCR 70 at 74-75 should be applied:

> *The resolution of the second issue of construction is to be found in the analysis by Sundberg J in* Zeta Force Pty Ltd v Commissioner of Taxation *… . His Honour dealt with the first issue of construction to the same effect as that just explained, saying:*
>
> > *"The words 'income of the trust estate' in the opening part of s 97(1) refer to distributable income, that is to say income ascertained by the trustee according to appropriate accounting principles and the trust instrument. That the words have this meaning is confirmed by the use elsewhere in Div 6 of the contrasting expression 'net income of the trust estate'. The beneficiary's 'share' is his share of the distributable income."*
>
> *Sundberg J then continued:*
>
> > *"Having identified the share of the distributable income to which the beneficiary is presently entitled, s97(1) requires one to ascertain 'that share of the net income of the trust estate'. That share is included in the beneficiary's assessable income. The expression 'net income of the trust estate' in par (a)(i) has the meaning given it by s 95(1) – taxable income as opposed to distributable income. The words 'that share' in par (a)(i) refer*

back to the word 'share' in the expression 'a share of the income of the trust estate', and indicate that the same share is to be applied to an income amount calculated according to a different formula (taxable income as opposed to distributable income). Since the income amount may differ according to which formula is applied, the natural meaning to give to 'share' where it appears for the second time is 'proportion' rather than 'part' or 'portion'. When Parliament wanted to convey the latter meaning, as it did in ss 99 and 99A, it used the word 'part'.

The contrast between the expressions 'share of the income of the trust estate' and 'that share of the net income of the trust estate' shows that the draftsman has sought to relate the concept of present entitlement to distributable income, and not to taxable income, which is, after all, an artificial tax amount. Once the share of the distributable income to which the beneficiary is presently entitled is worked out, the notion of present entitlement has served its purpose, and the beneficiary is to be taxed on that share (or proportion) of the taxable income of the trust estate."

4.17 For the 2000 income year, the "net income" of the Trust included the amount of $191,701 which should not have been claimed as a deduction in the tax return of the Trust. As a result, the High Court held that the assessable income of Mr and Mrs Bamford should include a share of that amount, equivalent to the share they each received of the distributable income.

Whether the trust deed could re-characterise amounts

4.18 The trust deed of the Trust gave the trustee the discretion to determine whether a particular receipt should be treated as income or capital.

4.19 The trustee relied on this power to pass a resolution to distribute the first $60,000 of net income, "*… including …* [the] *…. capital gain …*" to Mr and Mrs Bamford in equal shares.

4.20 The Commissioner argued that the capital gain was not income of the Trust. Further, since there was no income, no beneficiary could be 'presently entitled' to the amount in question, the trustee of the Trust should be assessed at the special rates.

4.21 The High Court held that the term "income" as contained in s 99A of the 1936 Act should be interpreted as income of the trust estate, as understood in trust law.

4.22 As a result, the net capital gain of the Trust became the income of the Trust after the trustee exercised its discretion to characterise the capital gain as income of the Trust.

Outcome for Trust Distributions

4.23 There is no room for doubt that Bamford establishes that:

4.23.1 income of the trust estate identified in s 97(1) of 1936 Act is to be determined according to any directions set out in the Trust Deed;

4.23.2 the share of the net income attributable to a beneficiary is to be determined in the same proportions in which the beneficiary enjoys the present entitlement to the share of the income of the trust.

4.24 In this first regard, the Court made it clear that the general rules regarding apportionment between capital and income of receipts and outgoings was largely based on assumptions which could be displaced by the terms of the trust instrument: Bamford at [17]. The general law of trusts operates to give meaning to the term "the income of the trust estate".

4.25 The determination of present entitlement to a share of the income is a process of trust administration. The decision of the Full Court of the Federal Court in *C of T v Totledge Pty Ltd* (1982) 40 ALR 385 at 393 is quoted in support: Bamford at [39]. The High Court distinguished its own decision in *C of T v Australia and New Zealand Savings Bank Ltd* (1998) HCA 53 (Bamford at [39]) as not relevantly addressing the issue. Finally, the Court observed that the Commissioner's lack of consistency in wishing to exclude "statutory income" from "income of the trust estate" did not assist his argument that "income" means "income according to ordinary concepts": Bamford at [41].

4.26 On the meaning of the term "share of the net income" the High Court adopted the proportionate approach advocated by Sunberg J in *Zeta Force* (discussed above).

4.27 What does this translate into for trustees making decisions in respect of trust distributions for the 2010 income year?

4.28 There are a number of relevant observations to be made.

4.29 First, if the Trust Deed provides a formula for determining the income of the trust then that formula will determine the entitlement of the beneficiaries to income. If, for example, the Deed contains words to the following effect:

> *"The net income of the trust is an amount equal to the amount determined in accordance with subsection 95(1) of the* Income Tax Assessment Act 1936 *but reduced by any amount which would otherwise be included by application of Division 207 of the* Income Tax Assessment Act 1997*".*

4.30 Throughout this paper "subsection 95(1) terms" means an amount adjusted for the franking credit gross up. The issue of grossing up is considered below in the context of using the full tax exemption including the franking rebate available to children.

4.31 Leaving aside the elimination of any gross up for franking credits (which itself is affected by the Streaming Amendments as discussed below) the amount of net income for trust law purposes

will equal the tax law income. The two will coincide so that there should, in the ordinary course, be no amount assessable to the trustee under s 99A of the 1936 Act.

4.32 Secondly, if the Trust Deed is silent then "ordinary income" principles apply. Just what they are is difficult to say. The ATO has expressed the view that income of a trust is income according to ordinary principles. This is not the same thing as accounting income determined in accordance with accounting principles. It requires a dissection of receipts into:

4.32.1 income according to ordinary principles;

4.32.2 income which is not ordinary income;

4.32.3 capital receipts.

4.33 Following that dissection, the expenses must be apportioned accordingly.

4.34 This is, of course, all too much. Many trust deeds will have a clause like that in Bamford which allows the trustee to determine whether a receipt is capital or income. Others will have very broad powers allowing the trustee to determine the basis on which income of the trust is to be worked out.

4.35 If these powers exist they should be used to avoid uncertainty brought about by the "ordinary income" approach. If they do not exist then the deed should be to give the trustee such a power. Whether such an amendment will amount to a resettlement, which might have adverse capital gains tax (and stamp duty) consequences, is discussed at **paragraphs xx** below.

4.36 Thirdly, because the proportionate approach has prevailed, a strict application of that rule will mean that great care needs to be taken when seeking to direct a specific amount of tax law net income to a particular beneficiary with absolute certainty e.g. the maximum amount to a child which escapes the punitive rates under Division 6AA of the 1936 Act. This issue is illustrated in the Examples which follow.

4.37 Fourthly, the High Court decision says nothing about streaming of trust income. The matter was not in issue. The uncertainty about streaming of income according to its character remained unabated, until the Streaming Amendments.

4.38 Finally, the ATO has done away with the benevolent "capital beneficiary" approach set out in Practice Statement PSLA 2005/1 (GA) on and from 13 October 2010.

Examples

4.39 The best way to illustrate these points is by way of example. In the examples which follow the following facts apply in relation to the A Family Trust for the income year ended 30 June 2010:

Receipts:

rent	$50,000
net capital gain	$100,000

Expenses:

rental expenses	$10,000
interest	$20,000

4.40 The interest relates to the rental property only. The discountable capital gain was made on the sale of shares in a listed company. The intended beneficiaries are Mr and Mrs A and their two children both under 18.

4.41 Because of the low income rebate the following no-tax thresholds apply to minors:

Income Year end 30 June	**$**
2010	3,000
2011	3,333

4.42 If the income constitutes fully franked dividends the cash payment thresholds and grossed up taxable income amounts are:

Income Year end 30 June	**$ cash**	**$ taxable income**
2010	6,300	9,000
2011	7,000	10,000

4.43 These figures have considerable significance for trustees seeking to hit the no tax "sweet spot" for a distribution to a child.

(a) Subsection 95(1) terms apply – no "balance approach"

4.44 The taxable capital gain is $50,000. Accordingly, the distributable trust income is $70,000.

4.45 For 2010 a minor may be distributed $3,000 with no tax liability if entitled to the low income rebate (see comments above).

4.46 The trust distribution minutes might give effect to the following:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000

70,000

4.47 The tax law results will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.48 The cash in the trust will include the $50,000 covered by the 50% general CGT discount. This is not income and can be dealt with as capital. As this is a discretionary trust it can be distributed without tax consequences.

(b) Ordinary income applies – no "balance approach"

4.49 In this instance the trust distribution minutes will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	7,000
Mr A	7,000
	20,000

4.50 The tax law results will be:

	$
Child 1	$3{,}000 + {}^{3,000}/_{20,000} \times \$50{,}000$
Child 2	$3{,}000 + {}^{3,000}/_{20,000} \times \$50{,}000$
Mrs A	$7{,}000 + {}^{7,000}/_{20,000} \times \$50{,}000$
Mr A	$7{,}000 + {}^{7,000}/_{20,000} \times \$50{,}000$

4.51 The final results:

	$
Child 1	10,500
Child 2	10,500
Mrs A	24,500

Mr A	24,500
	70,000

4.52 This is a strict application of the proportionate approach.

4.53 Each of the children will pay tax on $7,500 at the Division 6AA punitive rates of 45%. This is not a good result.

(c) Subsection 95(1) applies – "balance approach" used

4.54 Trust minutes:

	$
Child 1	3,000
Child 2	3,000
Mrs A	half of the balance
Mr A	half of the balance

4.55 Trust income entitlements:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.56 The tax law result:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.57 This is the same outcome as where no "balance approach" is applied – but see below for the effect of a tax adjustment.

(d) Ordinary income applies – "balance approach" used

4.58 Trust minutes

	$
Child 1	3,000
Child 2	3,000
Mrs A	half of the balance
Mr A	half of the balance

4.59 Trust income created will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	7,000
Mr A	7,000
	20,000

4.60 The tax law results will be:

	$
Child 1	$3{,}000 + {}^{3,000}/_{20,000} \times \$50{,}000$
Child 2	$3{,}000 + {}^{3,000}/_{20,000} \times \$50{,}000$
Mrs A	$7{,}000 + {}^{7,000}/_{20,000} \times \$50{,}000$
Mr A	$7{,}000 + {}^{7,000}/_{20,000} \times \$50{,}000$

4.61 The final results:

	$
Child 1	10,500
Child 2	10,500
Mrs A	24,500
Mr A	24,500
	70,000

4.62 Again there is no difference. However, the "balance approach" is more realistic because it is unlikely that the trust income or tax law income will be known as at any 30 June. In reality these figures are not known until the accounts are drawn later in the calendar year.

(e) Tax Law Adjustments

4.63 It is often important to anticipate an adjustment to the trust's tax law income especially where there is something contentions going on.

4.64 As has been seen the tax law result will follow on a proportionate basis the entitlements to income created under the Deed. To test the outcome it is assumed in the above examples that the trustee failed to recognise $10,000 of rental income (say the trustee at first considered that the income was to be deferred until the 2011 income year) but was in fact wrong about this.

4.65 How do the various approaches deal with such an adjustment?

Example (a) – subsection 95(1) applies (but no "balance approach")

4.66 The trust law entitlements and tax law results were the same:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.67 The tax law adjustment will increase both the trust law entitlement and the tax law income by $10,000. The Trustee has not dealt with this $10,000 and, without an operative default beneficiary clause, it will be assessed to the Trustee under section 99A of the 1936 Act.

4.68 The trust law entitlements and tax law result will be:

	$
Child 1	3000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
Trustee	10,000
	80,000

4.69 However, if there is no streaming of the capital gain (with the effect that all beneficiaries are entitled to a proportionate part of the capital gain) that part of the capital gain reflected in the income to which no beneficiary is presently entitled will be grossed up for the loss of the 50% general CGT discount. Five eighths of the $10,000 adjustment assessed to the Trustee is capital gain. As a result the share of the net income assessable to the Trustee will be increased by $6,250.

4.70 The final result will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
Trustee	16,250
	86,250

4.71 This is a costly outcome.

Example (c) – subsection 95(1) but using a "balance approach".

4.72 The trust law entitlement and tax law result were the same.

	$
Child 1	3,000
Child 2	3,000
Mrs A	half of the balance
Mr A	half of the balance

4.73 The unadjusted result was:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.74 The adjusted trust law entitlement and tax law result will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000 + 5,000
Mr A	32,000 +5,000
	80,000

4.75 The "balance approach" together with adoption of s 95(1) terms directs all of the tax law result from an adjustment made by the ATO to the balance beneficiaries.

4.76 If the balance distribution has been used Mr and Mrs A will "enjoy" a further $5,000 of income entitlement (it now having been correctly determined) and a further $5,000 of tax law net income each. No amount will be assessed to the trustee.

4.77 There is an argument that the beneficiaries have not become presently entitled to the amount of the adjustment to the trust law net income as it was not ascertained at the end of the income year. In the writer's opinion the trust law net income was always the amount as correctly adjusted by the ATO. There was never any uncertainty about it. It is simply the case that the trustee and ATO had not properly determined the correct quantum of income.

4.78 In practical terms how have the Courts looked at the "balance approach"? It has not come up that often.

4.79 The decision of Cooper J in *BRK (Bris) Pty Ltd v C of T* [2001] FCA 164 might at first blush give cause for concern. There the Court considered the operation of the default beneficiary clause in the Trust Deed. The distributions had been:

1993 income year:

"Hendon Unit Trust 100%

and Resolved that should the Commissioner of Taxation disallow any amount as a deduction or include any amount in the assessable income of the Trust, such amount or amounts are to be deemed distributed on 30th June 1993 in the same proportions as listed above to the beneficiaries listed above".

1994 income year:

(a) The sum of $304,021.72 to Westside Commercial Centre Pty Ltd as trustee of the Hendon Unit Trust for its absolute benefit.

(b) The following sums to the following beneficiaries for their absolute respective benefits: NIL

(c) The Balance to Jessica Wagner and Bill Wagner equally between them for their absolute benefit.

1995 income year:

Hendon Unit Trust	*First $220,000*
Northbourne Trust	*Next $100,000*

Wilhelm J Wagner and Jessica O Wagner	*Remainder of balance equally*

4.80 The same "variation of income" clause as in 1993 applied in this year.

4.81 It would appear that the Trust Deed did not adopt subsection 95(1) terms and that income was ordinary income.

4.82 It was found that the Hendon Unit Trust was not an object of the Trust and the distribution of income to it failed. The default beneficiaries clause distributed income in default of appointment to the beneficiaries described in the Schedule to the Deed as tenants in common. This was the usual wide class of family objects.

4.83 The Court concluded that the default beneficiary clause did not operate as at 30 June because the trustee had a reasonable time after the end of the income year in which to decide to distributed or accumulate.

4.84 The question arose as to whether the balance clause in the 1994 and 1995 determinations operated to take the amounts which the Trustee had attempted to distribute to the Hendon Unit Trust to Mr and Mrs Wagner. It was concluded that this was not the effect of the distribution minute and, as a result, the Trustee was assessable under section 99A.

4.85 At [40] Cooper J concluded:

> *"In my judgment the submission is misconceived. In the 1994 income year the clear intention of the applicant was to appoint to Mr and Mrs Wagner only so much of the Trust income, if any, as exceeded $304,021.72 in addition to any income in excess of that amount in the event that the appointment to WCC should fail. The position is no different in respect of the 1995 year. The trustee purported to appoint discrete amounts of income to the Hendon Unit Trust as to the first $220,000 and to the Northbourne Trust as the next $100,000. Finally, as to any remainder after the application of the first $320,000 of income, that remainder was to be appointed to Mr and Mrs Wagner; they did not as a matter of construction or intention on the part of the trustee, take by default all of the income in the event of failure of the other two appointments."*

4.86 Rather than being a cause for concern about the "balance approach" the decision of Cooper J on this point supports its operation. The specific quantum entitlements fix the income (and tax where s 95(1) terms apply) at the amount specified in the Trustee's determination. If the gift fails it does not flow to the balance beneficiary but to the default beneficiary or, in the alternative, there is no such entitlement created, giving rise to a s 99A assessment to the trustee.

4.87 Further comfort can be obtained from observations made in *C of T v Ramsden* [2005] FCAFC 39. In that case the Court was concerned with the issue whether a beneficiary had effectively renounced a distribution of income.

4.88 The distribution minutes for the 1996 income year provided:

"Steve Hart Family Holdings No.2	*$17,295*
Steve Hart Family Holdings No.3	*$6,639*
Unlimited Aerobatic Discretionary Trust	*$34,810*
The Adcock Practice Trust	*$429,000*
Troy B Hart	*$4,750*
Steven I Hart	*The Balance"*

4.89 It was agreed that the Adcock Practice Trust did not qualify as a beneficiary. The default beneficiary clause provided for income which had not been appointed prior to year end to be held for Steven Hart and his three children as tenants in common. The ATO assessed each of the default beneficiaries to one quarter of the amount which had failed to be appointed to the Adcock Practice Trust.

4.90 The argument was pressed before the primary judge that the income should pass by way of the balance distribution to Steven Hart: Ramsden at [38] to [41]. Justice Spender's rejection of this argument was confirmed by the Full Court. It was observed at [2005] FCAFC 39 at [72]:

> *"We agree with this construction. 'The Balance' does not include the amounts which precede "The Balance" in the resolution of 30 June 1996.*
>
> *'The Balance' is the Income of the Trust for the year ended 30 June 1996 other than the amounts which precede it in the resolution in question, whether effectively appointed or not".*[2]

4.91 This observation supports the "balance approach" taken in this paper where there have been effective distributions. Note, however, that it will not work where a distribution is ineffective. In such a case the adjustment will be assessed to the default beneficiary, if there is one, or to the trustee.

Example (d) – Ordinary Income with balance approach applying

4.92 The trust law entitlements were:

	$
Child 1	3,000

[2] [2005] FCAFC 39 at para. 72.

Child 2	3,000
Mrs A	half of the balance
Mr A	half of the balance

4.93 Trust income entitlements:

	$
Child 1	3,000
Child 2	3,000
Mrs A	7,000
Mr A	7,000
	20,000

4.94 The tax law result was:

	$
Child 1	10,500
Child 2	10,500
Mrs A	24,500
Mr A	24,500
	70,000

4.95 When the tax law income is adjusted by $10,000 there is no change to the trust law result. The tax law result will be:

	$
Child 1	$10,500 + {}^{10,500}/_{70,000} \times \$10,000$
Child 2	$10,500 + {}^{10,500}/_{70,000} \times \$10,000$
Mrs A	$24,500 + {}^{24,500}/_{70,000} \times \$10,000$
Mr A	$24,500 + {}^{24,500}/_{70,000} \times \$10,000$

4.96 The final result will be:

	$
Child 1	12,000
Child 2	12,000
Mrs A	28,000
Mr A	28,000

	80,000

4.97 The result has only become worse from a Division 6AA income perspective.

Will a "default beneficiary" clause in the Deed assist?

4.98 An income default beneficiary clause would be expressed something like:

> *"If the Trustee has not determined to distribute all of the net income of the Trust by the end of the Income Year the Income Default Beneficiary will be absolutely entitled to that part of the net income which has not been distributed."*

4.99 The term "Income Default Beneficiary" will be appropriately defined to identify individuals or companies.

4.100 In Example (a) – subsection 95(1) terms but no "balance approach" – a default beneficiary clause would have deflected the tax adjustment from the trustee to the default beneficiary.

4.101 In Example (b) – ordinary income but no "balance approach" – the default beneficiary clause would have no effective operation as all of the trust law/tax law income has been accounted for.

4.102 The trust entitlements were:

	$
Child 1	3,000
Child 2	3,000
Mrs A	7,000
Mr A	7,000
	20,000

4.103 The tax law result was:

	$
Child 1	10,500
Child 2	10,500
Mrs A	24,500
Mr A	24,500
	70,000

4.104 If the tax law income is increased by $10,000 the trust law income does not alter. The tax law adjustment is apportioned according to the trust law income apportionments, as follows:

	$
Child 1	10,500 + $^{3,000}/_{20,000}$ x 10,000
Child 2	10,500 + $^{3,000}/_{20,000}$ x 10,000
Mrs A	24,500 + $^{7,000}/_{20,000}$ x 10,000
Mr A	24,500 + $^{7,000}/_{20,000}$ x 10,000[3]
	70,000

4.105 The final tax results will be:

	$
Child 1	12,000
Child 2	12,000
Mrs A	28,000
Mr A	28,000
	80,000

4.106 In Example (c) – subsection 95(1) terms and a "balance approach" – the default beneficiary clause has no role to play because the adjustment will always be directed to the balance beneficiary.

4.107 In Example (d) – ordinary income and "balance approach" – the default beneficiary clause has no need to operate because the tax adjustment will simply be apportioned in accordance with the trust law entitlements which don't change.

Summary re Tax Adjustments

Trust Accounting Basis	Tax Law Income	Trust Income	Adjustment to (if no default beneficiary)	Adjustment to (if there is a default beneficiary)
subsection 95(1) – no "balance approach"	+ $100	+ $100	Trustee	Default Beneficiary
subsection 95(1) – "balance approach"	+ $100	+ $100	Balance Beneficiaries	Balance Beneficiaries
ordinary income – no "balance approach"	+ $100	no change	All Beneficiaries	All Beneficiaries
ordinary income – "balance approach"	+ $100	no change	All Beneficiaries	All Beneficiaries

[3] The proportions remain the same whether the trust law or tax law results are used.

Guidance from Bamford

4.108 As the High Court observed in Bamford at [17]:

> *"… both sides in argument on the present appeals accepted that whichever of the competing constructions of Div 6 were accepted examples could readily be given of apparent unfairness in the resulting administration of the legislation"*

4.109 In reaching the conclusion that the terms of the Trust Deed determine the trust income to which a beneficiary may be made entitled the High Court has gone very far towards resolving most of the problems and uncertainties which confronted practitioners and the trustees and beneficiaries they advise. With a good understanding of the terms of the Trust Deed as they effect trust distributions most distribution problems can be addressed.

4.110 As has been demonstrated in the above worked examples adopting a s 95(1) terms plus "balance approach" achieves the following:

4.110.1 the quantum of tax distribution to children can be locked in.

4.110.2 any "normal" tax adjustment will flow to the balance beneficiaries.

4.110.3 if used in conjunction with a default beneficiary clause ineffective distributions can also be dealt with.

4.111 The subsection 95(1) but without a "balance approach" can lead to:

4.111.1 an assessment of the tax adjustments to the trustee under section 99A;

4.111.2 clawback of any general CGT discount.

4.112 This can be addressed by using a default beneficiary (of course the default beneficiary should not be a company where the general CGT discount is involved).

4.113 The balance approach together with a considered default beneficiary is to be preferred as the outcome is more predictable.

4.114 The ordinary income approach is problematic because it is:

4.114.1 too difficult to calculate what is net ordinary income;

4.114.2 and tax law adjustments will be spread across all beneficiaries (as there is no adjustment to the net income).

5. Div 7A Amendments

5.1 Division 7A of Part III of the 1936 Act deals with accessing wealth in private companies without accounting for the tax that would otherwise be payable on the value accessed. It focuses on three means of accessing wealth in private companies – payments from a private company, loans from a private company or the forgiveness of a debt by a private company to an associate of that company.

5.2 In 2010 there were two broad changes to the Division 7A interacts with trusts:

5.2.1 The Div 7A Amendments; and

5.2.2 The Commissioner's position in *Taxation Ruling 2010/3* and *Practice Statement Law Administration* 2010/4.

5.3 The changes to Division 7A include the insertion of an introductory note to Division 7A stating:

> An amount may also be included in the assessable income of a shareholder or shareholder's associate if:
>
> (a) a company has an unpaid present entitlement to income of a trust; and
>
> (b) the trustee makes a payment or loan to, or forgives a debt of, the shareholder or associate.
>
> (See Subdivisions EA and EB.)

5.4 This note is of interest as it strongly suggests that Subdivision EA is a 'code' which is intended to capture arrangements where there is an unpaid present entitlement subsisting between a trust and a corporate beneficiary and there is then a loan, payment or forgiveness that occurs between the trustee and a shareholder or an associate of a shareholder in the corporate beneficiary.

5.5 This should be contrasted with the position in the ATO *Taxation Ruling* 2010/3 where the ATO assert that subdivision EA has much more limited effect, where they generally restrict its operation to the situation where there is a sub-trust in existence between a trustee and a corporate beneficiary and there is then loan, payment or forgiveness involving a shareholder or an associate of a shareholder and the trustee of the sub-trust.

5.6 In the 31 March 2010 NTLG meeting the professional bodies questioned the ATO as to whether the introduction of this provision into Division 7A cast doubt on the position in their draft ruling. The meeting agenda includes the following discussion:

> The ATO does not see a conflict between the legislation of provisions dealing with unpaid present entitlements and the position set out in Draft Ruling TR 2009/D8.

This is because, contrary to the premise of the question, under Draft Ruling TR 2009/D8 unpaid present entitlements will retain that status for Division 7A purposes in many situations, including where:

- the amount representing the UPE is physically held on sub-trust for the sole benefit of the private company beneficiary;
- the amount representing the UPE is being used by the trustee but all benefits from this use are held for the sole benefit of the private company; or
- the private company beneficiary is not aware and cannot be taken to be aware that the funds representing its UPE are being used for the potential benefit of any or all discretionary objects of the trust (rather than being physically set aside or used for its sole benefit).

The ATO has appropriately consulted with Treasury prior to and during the drafting of TR 2009/D8.

Provisions within Division 7A dealing with unpaid present entitlements will continue to have their intended application and there is no inconsistency between the Exposure Draft legislation and the draft Ruling.

Use of assets

5.7 As was announced in the 2009/10 Federal Budget the use of assets owned by private companies, or owned by trusts where there is a present entitlement owing to a private company may be subject to tax after 1 July 2009.

5.8 The way in which the use of assets will become subject to tax is through the amendment of the definition of the term 'payment' in Division 7A so that it extends to the provision of an asset (other than a transfer of property) for use by an entity. Consistent with the present operation of Division 7A the provision of the asset will only result in Division 7A consequences where the asset is provided to a shareholder or associate of a shareholder.

5.9 For the purposes of Division 7A the payment will occur when the use of the asset occurs.

5.10 A payment will also arise however where the asset is not used, but is available for use. The examples in the EM are illustrative of when it will be the right to use the asset, and not its use, that is subject to the Division 7A rules.

> ***Example (right to use from EM)***
> ***Brian is a shareholder of a private company that owns a luxury yacht. He does not have a formal agreement with the company in relation to the yacht, however, he takes the yacht out every second weekend.***
>
> ***Brian keeps the yacht at the company's business premises, but takes the key home. Brian stores several personal items on the yacht.***
>
> ***Brian's fortnightly use of the yacht is a payment under Division 7A. The availability of the yacht for Brian's use is also subject to Division 7A because the yacht is not readily available for use by the company. The company would need to arrange with Brian to***

get the key and for the removal of Brian's personal items before using the yacht. That is, the asset is available for Brian's use to the exclusion of the company.

Example (use from EM)
Marina is a shareholder of a private company that owns a city apartment. The apartment is generally available for rent. However, Marina asks the company not to rent the apartment out for a week so that she and her family can use the apartment over a long weekend. Marina's use of the apartment is a payment for the purposes of section 109CA.

5.11 An issue that arose on consultation over the draft legislation giving effect to these changes was whether the mere availability of assets to a shareholder or associate would result in the shareholder or associate being treated as having the asset available for their use. The EM again includes an example where there a payment is not taken to arise where an asset is available as a result of a general entitlement to use an asset without actual use of the asset.

Example (mere entitlement from EM)
Peter is a shareholder of a private company that owns five cars for company use. Shareholders and their associates have general permission to use the cars on weekends if they are not being used for company business. Peter regularly takes one of the cars home.

Peter's use of the car that he takes home will be subject to Division 7A. This will include driving the car (actual use) and the availability of the car for his use to the exclusion of the company, such as when it is parked at home, or at a restaurant that Peter is visiting.

Although Peter may have general permission to use all five of the cars, he does not use all of them for the purposes of Division 7A. The four cars that Peter leaves at the company premises are available for the company to loan to another shareholder, employee, customer, or other party. That is, these cars are not available to Peter to the exclusion of the company.

5.12 The EM also includes examples of where an asset is available to more than one shareholder or associate and it is necessary to determine who is taxed. The EM suggests and apportionment of the taxable value to the person who is the real recipient of the benefit. One example sets out that a minor that benefits should not be taken to receive a Division 7A payment, where another sets out that incidental use by a spouse of a vehicle provided to a shareholder would not result in the spouse being taxed on the benefit provided.

5.13 In valuing the payment taken to be made it will be the amount that would have been paid for the use of the asset in an arm's length dealing less any consideration paid that will be determined to be the payment for Division 7A purposes.

5.14 There are a number of exceptions from the payment provisions applying, including one not previously announced dealing with residential property:

5.14.1 Minor benefits – if the provision of the asset would have been a minor benefit under section 58P of the FBTAA had it been provided to an employee then the benefit will be disregarded for Division 7A purposes

5.14.2 Otherwise deductible payments – if a once off deduction would have been available to the shareholder or their associate in connection with the use of the asset then there will be no benefit to be taken into account for Division 7A purposes.

5.14.3 Dwellings – the use of a dwelling can be exempt where the following conditions are satisfied:

5.14.3.1 the entity or their associate is carrying on a business;

5.14.3.2 the entity or their associate uses or is granted or has a lease, licence or other right to use land, water or a building for the purpose of carrying on the business; and

5.14.3.3 the provision of the dwelling to the entity is connected with that use or with that lease, licence or other right to use the land, water or building to carry on the business.

5.14.4 Main residences – the provision of a dwelling that is a person's main residence does not result in a Division 7A payment where:

5.14.4.1 The provider of the dwelling is a private company;

5.14.4.2 The private company acquired the dwelling before 1 July 2009; and

5.14.4.3 The private company would pass COT from the time that the dwelling was acquired until the end of the time that a payment could be taken to be made under Division 7A.

5.14.5 Vacant land – if the exception for a dwelling or a main residence applies, it will extend to adjacent land in the same way as occurs in the main residence exemption.

Corporate limited partnerships

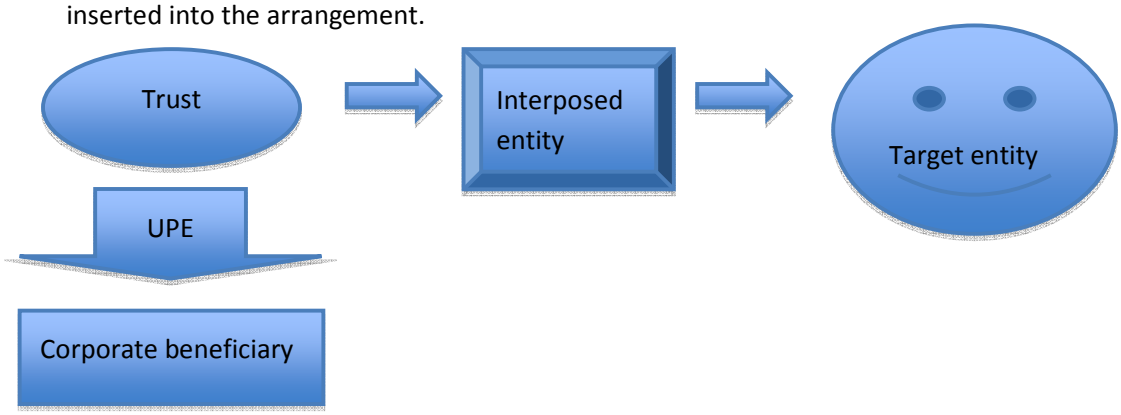
5.15 Closely held corporate limited partnerships (limited liability partnerships) will also now be subject to Division 7A. A corporate limited partnership will be closely held where it has fewer than 50 members or where an entity has, directly or indirectly, for the entity's own benefit, an entitlement to 75% or more of the income and capital of the partnership.

Interposed entities

5.16 The Div 7A Amendments fix two drafting issues in relation to the use of interposed entities.

5.17 The Division 7A legislation as originally drafted allowed for a payment by a private company through an interposed entity to be treated as a payment for Division 7A purposes.

5.18 The legislation did not however on a plain reading, allow for a trust where there was an unpaid present entitlement, to be deemed to have made a payment where an interposed entity was inserted into the arrangement.



5.19 A payment from the trust through an interposed entity to a target entity will now be caught by Division 7A if a reasonable person would consider that a loan or payment made to the interposed entity was made to enable a loan or payment to be made by the interposed entity to the target entity.

5.20 Consistent with the current operation of Subdivision EA however, a payment through to the target entity will only result in a Division 7A deemed dividend if it is referable to a reduction in a present entitlement that is in itself attributable to an unrealised gain in the trust.

5.21 The Div 7A Amendments also ensures that where an unpaid present entitlement is owed to a company by a trust, but the loan, payment or forgiveness that occurs does not involve the trust that owes the unpaid present entitlement, that Subdivision EA still has effect.

5.22 Subdivision EA will apply to treat a loan or payment from a trust as being a Division 7A loan or payment to the extent that the loan or payment is referable to an unpaid present entitlement owed to a private company where that amount has not already resulted in a Division 7A loan or payment.

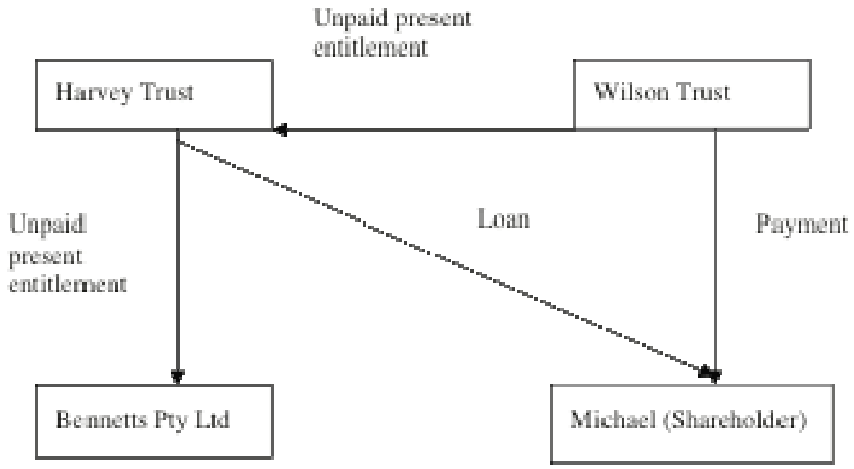
Example (interposed trust from EM)
Michael is a shareholder of Bennetts Pty Ltd and Bennetts Pty Ltd is a beneficiary of Harvey Trust. In the 2009-10 income year, Michael receives a payment from the trustee of the Wilson Trust, which is attributable to an unrealised gain. He receives this payment

because of his shareholding in Bennetts Pty Ltd. Michael also receives a $2,000 non-compliant Division 7A loan from the Harvey Trust.

Bennetts Pty Ltd is not presently entitled to an amount from the net income of the Wilson Trust. However, Bennetts Pty Ltd is entitled to $10,000 from the net income of the Harvey Trust (the first interposed trust) and Harvey Trust is presently entitled to $10,000 from the net income of the Wilson Trust. These amounts remain unpaid.

The loan made by the Harvey Trust to Michael will be included in Michael's assessable income under ordinary operation of subsection 109XA(2).

Bennetts Pty Ltd is taken to be presently entitled to $8,000 from the Wilson Trust, which is the unpaid present entitlement of $10,000 from the Harvey Trust, reduced by the $2,000 loan amount that is included in Michael's assessable income under another provision of Subdivision EA.



Loan back arrangements

5.23 Subdivision EA as currently drafted only captures payment arrangements where the payment is a reduction of a present entitlement that is referrable to an unrealised gain.

5.24 To circumvent these rules, apparently it had been suggested that the following arrangement could be entered into:

5.24.1 An unpaid present entitlement exists to a private company, say of $100,000.

5.24.2 A payment is made by the trustee of the trust to a beneficiary of an amount far in excess of the UPE, for example $1 million.

5.24.3 The amount in excess of the UPE is then loaned back to the trustee, being $900,000.

5.24.4 Thus, the beneficiary now has a credit loan of $900,000.

5.24.5 In future years the trustee appoints income to the company and uses the funds to repay the credit loan.

5.25 The need for there to be a payment referrable to a reduction of an unrealised gain will be removed where the payment made to a beneficiary is in reduction of a loan made on or after 1 July 2009 where a reasonable person would conclude that the trustee obtained the loan in order to make the payment.

Amendment to distributable surplus definition

5.26 The definition of distributable surplus will be amended so that amounts that have been deemed to be dividends as a result of the operation of Subdivision EA will be removed from the distributable surplus (by being correctly included as non-commercial loans).

Forgiveness of 109XB loans

5.27 There is a drafting problem that will be rectified so that the forgiveness of a loan by a trustee that has already been deemed to be a dividend will not result in a subsequent dividend. The law already applies in this way to the forgiveness of a debt owed to a private company by a shareholder that has already been deemed to receive a dividend under Division 7A.

Dividend set-off

5.28 Another drafting problem dealing with dividend set-offs will also be rectified.

5.29 At present, where a private company makes a loan that is deemed to be a dividend and later pays an unfranked dividend that is set off against that loan the later dividend is not included in assessable income.

5.30 The ability to disregard the later dividend does not apply where the loan was made by the trustee of a trust and where the deemed dividend arose under section 109XB.

5.31 The ability to disregard a later unfranked dividend offset against a loan from a trustee is being introduced.

Setting off employment entitlements

5.32 Another unusual aspect of the interaction of Division 7A generally and Subdivision EA has been that employment related payments that are offset against loans by trustees do not count as repayments if there is a borrowing of a similar or greater amount to the amount repaid. This is in contrast to setting off such a payment against a loan by a company where the repayment is taken into account even if there is a further borrowing.

5.33 This anomaly is to be rectified.

Borrowing to repay

5.34 Under the previous law a repayment is disregarded where the repayment is made where a reasonable person would conclude the repayment was made in order to borrow a similar or greater amount. This prevents a person from borrowing funds during a financial year, repaying on 30 June, and then reborrowing the amount on 1 July.

5.35 While the law has operated in this way (with some exceptions for repayments that occur by way of offsetting assessable amounts such as the wages noted above) it arguably has not operated where, instead of repaying to borrow, a person borrows to repay. This was be remedied so that a borrowing to repay will also activate section 109R.

> ***Example (from EM)***
> ***Alicia obtains a loan of $10,000 from Cleary Pty Ltd. Alicia has until the lodgment day to repay the loan. Two weeks before the lodgment day Alicia obtains a further $10,000 from Cleary Pty Ltd. She then repays the original $10,000 loan a week before the lodgment day.***
>
> ***The repayment of the original $10,000 loan is not a repayment for the purposes of section 109D, because Alicia has borrowed a similar amount from Cleary Pty Ltd and in this case a reasonable person would conclude that the loan was obtained in order to make the repayment of the original $10,000.***
>
> ***The original $10,000 loan is treated as a deemed dividend subject to the distributable surplus of the private company.***

Adding back payments for Division 7A purposes

6. Streaming

6.1 The paper will no consider the importance of, and ability to, stream as it stood before the Streaming Amendments. Then it will consider the Streaming Amendments.

Pre-Streaming Amendments

6.2 As can be seen from the illustrations above the ability to stream income according to its character is very important. This is particularly the case for franked dividends and capital gains but there are other forms of income with tax characteristics that may also be important e.g. income from a foreign source, income which has been subject to TFN withholding tax.

6.3 The decisions in Bamford tell us nothing about streaming income for tax purposes.

6.4 Most modern trust deeds will give the trustee power to distinguish between classes of income and to characterise a particular amount of income as having been derived from a particular source. The Deed should also allow the trustee to allocate expenses to the different classes of income.

6.5 The law regarding streaming after the decision in *CPT Custodian Pty Ltd v Commissioner of State Revenue [2005] HCA 53* ("**CPT Custodian**") was quite uncertain. The decision of the High Court in *Charles v C of T [1954] HCA 16* ("**Charles**") has always been the centre of gravity of the character flow through approach. The decision in Charles was heavily criticised by the Court in CPT Custodian. The question is whether that criticism went to the maintenance of character or is restricted to the characterisation of the interest in the trust fund by looking through to the underlying assets.

6.6 The decision of the High Court in CPT Custodian, in the writers' views, stands for the proposition that a beneficiary has an equitable interest in the residue of the trust fund after the Trustee's indemnity has been satisfied. This residue is characterless, whether it be income or capital, as the trustee may at any time satisfy its right to be indemnified from the receipts (which themselves have character).

6.7 Notwithstanding these problems the ATO has consistently taken the view that the character of the income in the hands of the beneficiary is taken from the character of the receipts of the Trustee[4] even after taking into account the decision in *CPT Custodian*[5].

6.8 In the non-binding ruling IT2328 (now withdrawn) it was observed:

> *"For income tax purposes where a beneficiary in a trust estate is presently entitled to the net income or a share of the net income of the trust estate, that income as a general principle has the same character in the hands of the beneficiary as it had in the hands of the trustee."*

6.9 The most significant streaming issues concern capital gains and dividends. In the case of capital gains Division 115 of Part 3-1 of the 1997 Act proceeds on an implication that income entitlements will take on at least some part of the character of the capital gains derived by the trustee. There is no clear legislative follow through. The guidance found in Sesction 115-200 of the 1997 Act establishes the implied maintenance of character:

> *"This Subdivision sets out rules for dealing with the net income of a trust that has a net capital gain. The rules treat parts of the net income attributable to the trust's net capital gain as capital gains made by the beneficiary entitled to those parts."*

[4] see in particular ATO ID 2008/51 dealing with Division 13.3A of the SIS Regulations.

[5] see Taxation Ruling STR 92/13, IT2328, IT2512, IT2004 (withdrawn) and ATO ID 2007/108 (which is concerned with foreign sourced income and in respect of which subsection 6B(2A) of the 1936 Act also comes into consideration).

6.10 Subsection 115-215(1) is the nub of the provisions:

> *"The purpose of this section is to ensure that appropriate amounts of the trust estate's net income attributable to the trust estate's capital gains are treated as a beneficiary's capital gains when assessing the beneficiary, so:*
>
> *(a) the beneficiary can apply capital losses against gains; and*
>
> *(b) the beneficiary can apply the appropriate discount percentage (if any) to gains."*

6.11 The process is described as attribution rather than maintenance of source character. This may be the necessary distinction to make the rules work. There is, however, no guidance about how the attribution is to be carried out.

6.12 What is clear is that if there is no trust income to which the beneficiary is presently entitled there can be no attribution. This is a major issue where there is no trading income but there are capital gains in the Trust. Use of s 95(1) terms to describe income overcomes this problem and makes the case for attribution much clearer. The capital gain (or at least 50% of it) will be included in the income. The connection for Subdivision 115-C purposes is very clear.

6.13 The ATO has had to resort to the artificiality of the "capital beneficiary approach" in PS LA 2005/1 (GA) to achieve this sensible outcome – but this practice statement was withdrawn following Bamford.

6.14 The issues with streaming can be readily appreciated in the context of capital gains and the 50% general CGT discount. The streaming issue is, of course, the denial of the 50% CGT general discount when a trust to company distribution is in play.

6.15 Maintaining the example used above in which there is a net capital gain of $100,000, and gross rental income of $50,0000 and net rental income of $20,000.

6.16 In this instance the trustee wishes to cause the capital gain to be assessed in the hands of an individual (say Mrs A) and the net rental income in the hands of a company, A Co. If it is assumed that the Trust Deed has all of the usual income characterisation and streaming provisions and the Deed adopts subsection 95(1) terms, the outcome readily appears.

6.17 The income entitlements are:

	$	
A Co	20,000	comprising net rental income
Mrs A	50,000	comprising the capital gain
	70,000	

6.18 If the ATO took the view that streaming was unobtainable the outcome would be:

	$	$ Total
A Co	5,714 + taxable capital gain $28,572	34,286
Mrs A	50,000	50,000
		84,286

6.19 The other area of concern is franking credits. At least there is a ruling on this aspect of streaming, *Taxation Ruling* 92/13 (repealed as of 22 June 2011 because of the Streaming Amendments). The provisions of Subdivision 207-B and in particular ss 207-45 to 207-57 are consistent with flow through of the franked character of a dividend.

6.20 The fact the Example set out immediately below s 207-35(3) of the 1997 Act depends on character maintenance. It is worthwhile setting this Example out in full:

> *"A franked distribution of $70 is made to the trustee of a trust in an income year. The trust also has $100 of assessable income from other sources. Under subsection (1) the trust's assessable income includes an additional amount of $30 (which is the franking credit on the distribution). The trust has a net income of $200 for that income year.*
>
> *There are 2 beneficiaries of the trust, P and Q, who are presently entitled to the trust's income. Under the trust deed, P is entitled to all of the franked distribution and Q is entitled to all other income.*
>
> *The distribution flows indirectly to P (as P is entitled to a share of that net income and has a 100% share of the distribution under section 207-55). P therefore has an amount of assessable income that is equal to its share of the distribution. Under this subsection, P's assessable income also includes the full amount of the franking credit (as P's share of the franking credit on the distribution is $30 under section 207-57). Q's share of the net income therefore does not include any of the franking credit."*

6.21 Clearly the legislation contemplates maintenance of character for the purposes of dividend imputation.

Commissioner's Concern of Division 6 Abuses

6.22 As usual the ATO is driven by the possibility that the decision in Bamford might support some abuse and revenue loss. No matter that their interpretations lead to massive headaches for practitioners.

6.23 This much is exampled by several examples set out *in Practice Statement PS LA 2009/7* which was released prior to the decision in Bamford.

6.24 Examples 1 and 5 in particular show what the ATO is on about.

6.25 Example 1 concerns the trustee of a family trust deriving $250,000 in income during the income year and applying that income to the purchase of a holiday home. The trustee, acting in accordance with a power expressed in the terms of the Trust Deed to do so, determines that the expenditure on the purchase of the house is an outgoing on income account with the effect that the trust law income available for distribution is $5,000. One of the beneficiaries has tax losses.

6.26 The trustee distributes the $5,000 trust law income to the loss beneficiary. The losses cover the tax law income which follows the trust law income to the loss beneficiary.

6.27 The ATO expresses concern about the mismatch of the actual amount to which the beneficiary becomes entitled ($5,000) and the amount of the tax law income flowing to the beneficiary ($250,000) and the tax not paid because of the losses.

6.28 It is difficult to say why this is of concern to them. The true effect of the transaction is to maintain $245,000 in the capital of the trust. The same tax effect would be obtained by distributing all of the $250,000 to the loss beneficiary. There is no tax difference in this illustration. It is unlikely there would be a tax benefit for the purposes of Part IVA. The most likely explanation for the transaction is the financial risk the loss beneficiary has been exposed to. If the beneficiary became entitled to call on the trustee to pay him or her $250,000 the creditors may be able to stake a claim to that amount. It is a neat and sensible piece of asset protection planning.

6.29 Example 5 is about a trust which has distinct income and capital beneficiaries. The trustee has a power to determine whether receipts and outgoings are on income or capital account. The Trust Deed is amended to admit a tax exempt entity as a beneficiary.

6.30 The trust derives $100,000 of income (meaning income according to ordinary concepts) during the income year. The trustee determines that $95,000 of that amount is a capital receipt. The remaining $5,000 is the trust law income according to the Trust Deed. This amount is appointed to the tax exempt beneficiary. All of the tax law income will be assessed to the charity. It would follow that the trustee makes a capital distribution of the $95,000 to a family beneficiary.

6.31 The ATO observe in the Practice Statement that Part IVA might apply in the circumstances. In the writer's view it almost certainly would do so in particular because of the amendment to introduce the tax exempt charity as a beneficiary and the fact that prior year distributions had been made only to family members. A much more challenging (and perhaps more realistic) illustration would arise if the tax exempt charity was already an object and the trustee had made distributions to charities in the past. The Part IVA case in such circumstances would be difficult to make out. This is an example of the acknowledged "apparent unfairness in the resulting administration of the legislation" as noted by the High Court in Bamford at [17].

6.32 The ATO apparently accept that Bamford authorizes characterization of capital receipts as income for the purposes of the Deed but are not so ready to accept that ordinary income may be recharacterised as capital (as in Example 5). They appear to be fortified in this by observations made by the Full Court of the Federal Court in *Forrest v C of T* [2010] FCAFC 6 ("**Forrest**").

6.33 The relevant question before the Court there was whether Mr Forrest was entitled to a deduction for interest he had incurred in relation to funds he had borrowed to acquire units in a unit trust. The outcome turned on whether there was a fixed income component to which the funds related. The Full Court concluded that a power to determine whether any amount received by the trustee was on revenue account or capital account (clause 12 of the Deed) was not a power to change the beneficiaries' rights. In so doing they observed at [11]-[12]:

> *'In our opinion, the power conferred by cl. 12 cannot be exercised by the trustee wrongly to classify a receipt as a capital gain, when the receipt is, in truth, income, and thus deprive the appellant of his interest in the unit component of the trust. Clause 12 is not an unlimited power to be exercised in the trustee's unconfined discretion….*
>
> *Clause 12.2(a) is a power to determine how a distribution to beneficiaries is classified. That limited power is not a power which is capable of altering the beneficiaries' rights. Clause 12 is to be read consistently with the balance of the Trust Deed and an appreciation that it contains various powers of an administrative character. The words used can be given full force honestly to classify income or distributions according to law, as the appellant contended to this Court".*

6.34 It is very difficult to know how far this goes. The issue in Forrest was about whether or not the exercise of the power changed the rights as between classes of beneficiaries. Presumably the ATO would say that the exercise of the power in a case like that in Example 5 was not an "honest" classification of the receipt as capital. Hopefully the issue will not arise very often.

Point of Interest

6.35 A case of interest is *Greenhatch v FCT* [2011] AATA 479 that ostensibly concerned superannuation contributions where the answer to the superannuation question was determined by construing streaming through a trust. The case of is interest for two reasons.

6.36 First, the AAT went out of their way to note the Commissioner's interpretation of Bamford was wrong. At [49] and [50] they said:

> *Much, if not all, of the Commissioner's case turns on his rejection of any underlying conduit theory and his interpretation of the implications of the decision in Bamford.*

The Commissioner's contention that the conduit theory has no role to play is based on foundations with which we do not agree. Accordingly, those foundations do not support the conclusion he seeks to draw.

6.37 Secondly, in relation to Subdivision 207-B of the 1997 Act, being the franking credits provisions, the AAT observed at [63]:

> *Section 207-35 of the 1997 Act has an aspect that makes the conclusion [that] amounts passing through trusts to beneficiaries thereof carry the character and identity that they had in the hands of the trustee more compelling. That section includes an example that contemplates differential distributions in determining the taxation burdens that are imposed on the beneficiaries of the trust.*

6.38 Question: was it necessary to introduce the Streaming Amendments in light of the above comments? Given we have the Streaming Amendments it is of academic interest only.

Streaming Amendments

6.39 The *Tax Laws Amendment (2011 Measures No. 5) Act* 2011 (Cth) was introduced into parliament (as a Bill) on 2 June 2011, was passed unamended and assented to on 29 June 2011. They take effect from 1 July 2010. These dates show how close a call it was as the Streaming Amendments are critical for trustee decisions that were needed to be made on 30 June 2011 – one day after their royal assent.

6.40 Subject to a statement by the Commissioner – extending the time a trustee could make decisions to 31 August 2011, which has anyway passed, but the writers question the Commissioner's ability to alter what trust law[6] requires to be done on 30 June of any year – the Streaming Amendments apply to trustees resolving to deal with trust income and capital gains.

6.41 From the 2011 income year and thereafter taxable capital gains and franked distributions are dealt with under these rules.

6.42 The Streaming Amendments operate by diverting from Division 6 of the 1936 Act the franked distributions and taxable capital gains. They are assessed directly in the hands of the beneficiaries who are presently entitled to them. They do this via Subdivision 207-B of the 1997 Act for franked distributions and via Subdivision 115-C of the 1997 Act for taxable capital gains. However, for the taxable capital gains they must still pass through the method statement in s 102-5(1) of the 1997 Act.

[6] *Trustees of the Estate Mortgage Fighting Fund Trust v FCT* [2000] FCA 981 per Hill J; *Case R105,* 84 ATC 692; *Antonopoulos v FCT* [2011] AATA 431.

6.43 The Streaming Amendments have introduced a new Division 6E into Part III of the 1936 Act to prevent double taxation. It adjusts the Division 6 income and net income of the trust to take out the amounts to which the beneficiary has been made specifically entitled.

6.44 It can be seen that the specific entitlement of the beneficiary or beneficiaries is the critical aspect of the Streaming Amendments. This is required to determine tax liability.

Specific Entitlement

6.45 The notion of a specific entitlement conceals the difficulties of applying the Streaming Amendments to all trusts, be they discretionary, fixed, unit, et cetera. The mechanism by which you become specifically entitled are set out in the relevant Subdivisions: s 115-228 for capital gains and s 207-58 for franked distributions. The provisions seem substantially similar at first look but there are some significant differences.

6.46 A beneficiary is specifically entitled under s 207-58 of the 1997 Act to an amount of a franked distribution made by the trust equal to the amount calculated under the following formula

$$\text{Franked Distribution} \times \frac{\text{Share of net financial benefit}}{\text{Net financial benefit}}$$

6.47 The "net financial benefit" is an amount equal to the financial benefit referable to the franked distribution (after an application by the trustee of expenses that are directly relevant to the franked distribution).

6.48 The term "financial benefit" is already in s 995-1 f the 1997 Act. It means anything of economic value, even if the transaction also imposes an obligation on the entity. Benefits and obligations are to be looked at separately and not set off against each other, but it is the net financial benefit to which the formula looks.

6.49 The "share of the financial benefit" is the amount of the financial benefit referable to the franked distribution specifically linked to the particular beneficiary. The share of the net financial benefit is:

> *… an amount equal to the *financial benefit that, in accordance with the terms of the trust:*
>
> *a. the beneficiary has received, or can be reasonably expected to receive, and*
>
> *b. is referable to the *franked distribution (after application by the trustee of any expenses that are directly relevant to the franked distribution) and*
>
> *c. is recorded, in its character as referable to the franked distribution, in the accounts or records of the trust no later than the end of the income year.*

6.50 Section 115-228 is identical to the discussion above of franked distributions, subject to:

6.50.1 the financial benefit must be referable to the capital gain "after application by the trustee of any losses, to the extent that the application is consistent with the application of capital losses against the capital gain in accordance with the method statement in subsection 102-5(1)"; and

6.50.2 the recording of the financial benefit must be "no later than 2 months after the end of the income year."

Complexities and Going Forward

6.51 An issue to be mindful of is – in fact an issue of significant importance – is that a trust with no "income", which was one of the problems in the Bamford appeals, will not be able to stream franking credits. This will mean that where the franked distributions, together with other ordinary income, is insufficient to more than offset expenses of the trust the franking credits cannot go through to the beneficiaries. The same restriction does not apply in relation to capital gains streamed through the trust.

6.52 Ken Schurgott FTIA, in his paper in the August 2011 *Taxation in Australia* titled "Trust streaming 2011" notes a number of complications that arise from the Streaming Amendments:

> *As will be seen, there are a number of issues which emerge that complicate the legislation over and beyond the rather simple approach adopted prior to the Commissioner's stance on streaming. The things which complicate matters are:*
>
> *a. There can be different outcomes according to the definition of income adopted by the trust deed;*
>
> *b. Significantly different outcomes can result where a beneficiary has not been made specifically entitled to the franked distribution or capital gain. This is most pronounced in relation to capital gains;*
>
> *c. The concept of making a beneficiary entitled to the entire financial benefit from a capital gain or franked distribution is fraught with difficulty, particularly where there are capital losses or directly related expenses; and*
>
> *d. The way in which capital losses and directly related expenses are to be dealt with is confusing.*

6.53 It can be seen from these further issues, and the problem of actually apply what is a simple concept of diverting the amounts to Subdivisions 115-C and 207-B respectively, are anything but straightforward or settled. Indeed, a senior council on the writer's floor, after having advised on

the Streaming Amendments is of the view that this is where future archeologists will find the bones of 21st Century tax lawyers and accountants.

7. Changes to the taxation of trusts – terms to be provided for in a trust document

7.1 Given the changes in the taxation of trusts, it is recommended that trust deed (or any other constituent documents) be reviewed so as to determine:

7.1.1 How income, capital gains and outgoings are accounted for and determined; and

7.1.2 How income, capital gains and outgoings are to be distributed.

7.2 Some of the powers which may be advantageous to have within a trust instrument include:

7.2.1 an accounting policy which is sufficiently broad and allows the trustee to exercise maximum discretion;

7.2.2 the discretion to reclassify and allocate income and capital gains;

7.2.3 the discretion to reclassify and allocate outgoings;

7.2.4 the discretion not to recoup losses (whether income or capital in nature);

7.2.5 the ability to allocate and stream classes of income and capital and their related tax attributes;

7.2.6 and ensure that any unpaid present entitlement / loan provisions are removed, and an ability to hold amounts subject to a sub-trust.

7.3 Some additional powers to be considered include:

7.3.1 whether the trustee has the power to distribute income and / or capital at any time within a tax year;

7.3.2 whether any determination of income (or capital) can be made within the income tax year; and

7.3.3 whether the trustee has a power to determine entitlements with respect to an income tax year after the relevant year.

Accounting policy

7.4 Essential is ensuring that the trust deed provides guidance with respect to an accounting policy that should be used by the trustee. Such an accounting policy should provide sufficient flexibility for the trustee, so that it may depart from generally accepted accounting standards in the event that the trustee considers that it is appropriate to do so.

Reclassifying and allocating income and capital

7.5 As the High Court in *Bamford* accepted that the tax law income of a trust is dependent upon (amongst other things) the definition of that term in the trust deed, regard should be given to the definition of the 'income' as contained in the trusts constituent documents.

7.6 An issue to consider is whether attributed amounts (e.g. franking credits) should be included within the definition of trust income. An issue that arises is that if attributions are included in trust income (and which are not physically 'paid' by a trustee – but which follow certain amounts of income), whether by being included in trust income, and thereby providing that a trustee creates a 'present entitlement' in a beneficiary to an amount that is never received by a trustee, the trustee will be exposed to a claim in relation to amounts that are not actually received by the trustee.

7.7 It is submitted that amounts such as franking credits should be prima facie carved-out of the definition of income. However, the definition should contain discretionary elements to allow a trustee to cause such 'attributed' amounts to fall within the definition of income.

7.8 An approach which may be considered is, in defining trust income:

7.8.1 Provide that it prima facie equals the amount provided for in s 95(1) of the 1936 Act (less any franking credits);

7.8.2 If the tax law approach is not warranted for a particular tax period, then:

7.8.2.1 According to an accounting policy adopted by the trustee; or

7.8.2.2 Any other basis as determined by the trustee; or

7.8.3 In the trustee's absolute discretion, the gross income of the trust.

Reclassifying and allocating outgoings

7.9 In *Cajkusic v FC of T (No 2)* (2006) ATC 4752 ("**Cajkusic**") deductions allowable to a family discretionary trust for payments that were made under an employee benefits trust arrangement in the income tax years ending 30 June 1997 and 30 June 2008 caused there to be a loss within the trust estate.

7.10 As a result of the losses, there was no distributable income of the trust. As a result, the Full Court of the Federal Court held that the lack of distributable income meant that there could be no beneficiary of the trust (for the relevant income tax years) to be "*… presently entitled …*'"pursuant to s 97 of the 1936 Act to any amount.

7.11 It should be noted that the Commissioner's subsequent application for special leave to appeal to the High Court was rejected.

7.12 Cajkusic stands for the proposition that the 'distributable income' of a trust is determined by reference to proper accounting principles, as well as the terms of a trust deed. In this context distributable income is income determined according to accounting principles, and which is distributable amongst the beneficiaries. It does not alter either the income as calculated under accounting principles, of the 'net income' as determined under s 95(1) of the 1936 Act – rather, only gives a trustee the power to determine the distributable amounts.

7.13 As a result of the decision in Cajkusic, it is submitted that a trust deed should give a trustee the power to reclassify, and allocate outgoings, so that there can be 'distributable income' to which beneficiaries are presently entitled.

Discretion not to recoup losses (whether income or capital in nature)

7.14 It is recommended that a trustee have a discretion not to recoup losses (whether of an income or capital nature). That is, a power not to recoup losses which have arisen in the past.

8. Resettlement considerations

8.1 Whenever the terms of a trust are varied, an issue to consider is whether the variation amounts to a 'resettlement'.

8.2 Resettlements relate to changes to a trust relationship which have the effect that a new trust estate comes into existence. According to the High Court in *FC of T v Commercial Nominees of Australia Ltd* [2001] HCA 33 (***"*Commercial Nominees"**), the issue to determine is whether '*… what occurred* … [i.e. the variation] … *was a fundamental alteration in the trust relationship*

established by the original deed, such that it destroyed the necessary continuity of the 'taxpayer'…'.

8.3 A resettlement can have significant income tax, capital gains tax (**'CGT'**) and stamp duty consequences, including that:

8.3.1 the trust property may be disposed of, potentially triggering both stamp duty and CGT liabilities;

8.3.2 carried forward tax benefits may be lost; and

8.3.3 beneficiaries may dispose of their interests in the original trust and acquire interest in a new trust.

8.4 Specifically in the context of CGT, a resettlement may cause either CGT event E1 (s 104-60 of the 1997 Act) or CGT event E2 (s 104-65 of the 1997 Act) to happen.

8.5 In August 2001 the issued a Statement of Principles entitled *Creation of a new trust* (the **"Statement**"). The Statement clarifies when, in the Commissioner's view, changes to a trust gives rise to a new trust. The Commissioner considers that a new trust estate arises where there is a 'fundamental change to a trust relationship' – ie, a change in the essential nature and character of the original trust relationship. Further, the Commissioner considers that a new trust (i.e. a resettlement) may arise in the following circumstances:

- a change in beneficial interest in trust property;
- a new class of beneficial interest (whether introduced or altered);
- a redefinition of the beneficiary class;
- changes in the terms of the trust or the rights or obligations of the trustee;
- changes in the nature of the trust property;
- additions of property which could amount to a new and separate settlement;
- depletion of trust property;
- a change in the termination date of the trust;
- a change in the trust that is not contemplated by the terms of the original trust;

- a change in the essential nature and purpose of the trust; and / or
- a merger of two or more trusts or a splitting of the trust.

8.6 The Commissioner considers that depending on their nature and extent, the above changes may either amount to:

8.6.1 a variation of a continuing trust; or

8.6.2 a fundamental change in the essential nature and character of the trust relationship. In such a case, the original trust may be brought to an end and a new trust created. Whether a new trust is created depends on the terms of the original trust and on the powers of the trustee.

8.7 The High Court in Commercial Nominees held that significant changes to a superannuation fund trust deed did not create a new trust, even though the amending deed had:

8.7.1 changed the name of, and appointed a new trustee to the fund;

8.7.2 introduced a new category of beneficiaries;

8.7.3 changed the fund from a defined benefit fund to an accumulation fund;

8.7.4 appointed a professional management company as administrator; and

8.7.5 allowed membership to be promoted to the public.

8.8 The High Court in *Commercial Nominees* considered that there were three main indicators of the continuity of a trust relationship, being:

8.8.1 the constitution of the trust;

8.8.2 the trust property; and

8.8.3 the membership of the trust.

8.9 Substantial changes any of the above may cause a resettlement.

8.10 The High Court considered that, in order to destroy the necessary continuity, changes in one or more of the above indicators must be such as to terminate the existence of the entity, or to produce the result that the particular trust does not derive the income in question. It was held that the changes made to the trust deed in question were not sufficient to destroy the continuity, primarily because the fund was at all times governed by the same deed, the trust property did not change, and the members before the amendment to the trust deed remained members afterwards. We consider that the amendments discussed above will not cause a resettlement.

8.11 The Commissioner notes in the Statement that administrative changes, such as re-defining trust income (without more) may not cause a resettlement (depending on the context) as it may be administrative in nature.

8.12 However, regard will need to be given to the implications to the membership (i.e. the beneficial entitlements) of the trust, and what implications such an amendment will have on the respective entitlements in a trust. For example, an important consideration will be determining how unallocated / undistributed income is to be dealt with. For example, is such income:

8.12.1 accumulated, and form part of the corpus of the relevant trust estate;

8.12.2 is it distributed to certain default beneficiaries; or

8.12.3 is it held on trust for a specific purpose (e.g. a charitable purpose).

Changes in the Taxation of Trusts

A paper presented by Michael Bennett and Denis Barlin at the NSW Young Lawyers CLE

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Michael Bennett E bennett@sevenwentworth.com.au D 8224 3055 M 0408 029 416
Denis Barlin E dbarlin@wenworthchambers.com.au D 9231 6646 M 0404 848 311

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1. General overview

1.1 The income years ended 30 June 2010 and, more particularly, 30 June 2011 have been very active for the taxation of trusts. Significant events in three areas of trust taxplay activity:

1.1.1 decisions of the Courts and principally the High Court's decision in *Commissioner of Taxation v Bamford* (2010) 240 CLR 481; (2010) 264 ALR 436; [2010] HCA 10 ("**Bamford**");

1.1.2 legislative changes, principally:

1.1.2.1 the new rules set out in *Tax Laws Amendment (2011 Measures No. 5) Act* 2011 (Cth) (the "**Streaming Amendments**") that deal with taxation of franking credits and capital gains in trusts; and

1.1.2.2 the new rules set out in the *Tax Laws Amendment (2010 Measures No. 2) Act* 2010 (Cth) that are principally about Division 7A of Part III of the *Income Tax Assessment Act* 1936 (Cth) (the "**1936 Act**") and companies providing rights to use property, but also contain some trust issues (the "**Div 7A Amendments**"); and

1.1.3 Australian Taxation Office ("**ATO**") activities principally the very controversial draft ruling on unpaid present entitlements, TR 2009/D8.

1.2 Some of these changes have overtaken themselves. For instance, there was at the time – and this paper includes – a discussion of streaming post Bamford (see **heading 4** below). That discussion should be read as having been overtaken by the Streaming Amendments (see **heading 5**).

1.3 And what's more the change is not over. Chapter 2 of the explanatory memorandum to the Bill that introduced the Steaming Amendments makes it clear that the streaming provisions have been introduced as an interim measure to deal with perceived anomalies in the taxation of capital gains and franked distributions pending a comprehensive review of Division 6 of Part II of the 1936 Act.

1.4 The changes made so far give rise to issues themselves and further consequential issues for trusts. In addressing the issues – both outlined above and the consequential issues – this paper will discuss:

1.4.1 Taxation of trusts generally;

1.4.2 The competing views before Bamford;

1.4.3 The context of Bamford and what it means for trusts;

1.4.4 Briefly (as it is not germane to the other issues raised in the paper) what are the Div 7A Amendments and what they mean for trusts;

1.4.5 What are the Steaming Amendments and what they mean for trust;

1.4.6 What a trust deed needs in light of those three issues; and

1.4.7 Amending trust deeds to deal with those three issues.

1.5 The issues are dealt with in this order as they are chronological to their occurring.

2. Taxation of Trusts

2.1 The provisions dealing with the taxation of trust income are contained in Division 6 of Part III of the 1936 Act (which comprises of sections 95 to 102).

2.2 As a result of the enactment of Streaming Amendments, regard should also be given to:

2.2.1 Subdivision 207-B of the *Income Tax Assessment Act* 1997 (Cth) (the "**1997 Act**") – which deals with franking credits obtained by a trust estate; and

2.2.2 Subdivision 115-C of the 1997 Act – which deals with the distribution of capital gains by a trust estate.

2.3 Chief Justice Latham in *Tindal v FC of T* (1946) 72 CLR 608 at 618 observed that the object of Division 6 of the 1936 Act is to "*… secure payment of tax upon the whole of the net income of a trust estate, either from a beneficiary or the trustee, whether the income is paid over to or on account of the beneficiary …*". Further, according to Emmett J in *Bamford v Federal Commissioner of Taxation* (2009) 176 FCR 250 "*… an important assumption underlying Division 6 …* [is] *… that a beneficiary who derives a share of the net income should be in a position to pay out of that income; otherwise, the beneficiary could be placed in a difficult position*."

2.4 The starting point in determining the taxation of trust income is s 97 of the 1936 Act. Relevantly, s 97(1) of the 1936 Act 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; and

(b) the exempt income of the beneficiary shall include:

(i) so much of the individual interest of the beneficiary in the exempt income of the trust estate as is attributable to a period when the beneficiary was a resident; and

(ii) so much of the individual interest of the beneficiary in the exempt 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;

except to the extent to which the exempt income to which that individual interest relates was taken into account in calculating the net income of the trust estate; and

(c) the non-assessable non-exempt income of the beneficiary shall include:

(i) so much of the individual interest of the beneficiary in the non-assessable non-exempt income of the trust estate as is attributable to a period when the beneficiary was a resident; and

(ii) so much of the individual interest of the beneficiary in the non-assessable non-exempt 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]

2.5 That is, s 97 of the 1936 Act provides that where a beneficiary, who is not under a legal disability is presently entitled to a "*… share of the income of the trust estate …*", the assessable income of:

2.5.1 a resident beneficiary includes the beneficiary's share of the '*… net income of the trust estate …*'; and

2.5.2 a non-resident beneficiary includes so much of the beneficiary's share of the net income of the trust as is attributable to sources in Australia.

2.6 It should be noted that the term "net income of the trust estate" for the purposes of s 97 of the 1936 Act is defined in s 95(1) of the 1936 Act. However, the term "*… the income of the trust estate …*" as contained in s 97 of the 1936 Act is not defined in the 1936 Act.

2.7 Subsection 95(1) of the 1936 Act defines the term 'net income', in relation to a trust estate as:

> ***net income**, 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 Division 393 of the Income Tax Assessment Act 1997 (Farm management deposits) 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.*

2.8 For completeness, it should be noted that:

2.8.1 s 98 of the 1936 Act provides that the trustee is liable to tax on behalf of a beneficiary where the beneficiary is presently entitled to a share of the income of a trust estate, but the beneficiary is under a legal disability;

2.8.2 ss 99 and 99A of the 1936 Act apply to subject the trustee to tax where there is some part of the net income of a trust estate that is not subject to tax under either of ss 97 or 98 of the 1936 Act. The difference as between s 99 and s 99A of the 1936 Act is the rate of tax applicable. Typically, the trustee will be subject to tax under section 99A of the 1936 Act at a penal rate of tax equal to the maximum rate of tax (currently 45%). However, the Commissioner has a discretion to apply s 99 of the 1936 Act in certain circumstances, in which case the trustee will be subject to tax at the normal marginal rates of tax.

3. The two competing views before the decision in Bamford

3.1 There has been, for some time, two competing views in the taxation of trust income – the proportionate view and the quantum view.

Proportionate approach

3.2 *David & Anor v FC of T* 89 ATC 4377 contains an example of the application of the proportionate approach (which according to the High Court's decision in Bamford, is the correct approach).

3.3 The proportionate view looks to the share (or proportion) of trust law income of a trust to which a beneficiary is "presently entitled", and then applies that share or proportion to the net income of a trust estate to calculate how much of the net income is to be included in the beneficiary's assessable income.

3.4 As an example, if a beneficiary is entitled to one half of the trust law income, then the beneficiary must include half of the net income in their assessable income – irrespective of whether it is more or less than the amount of the trust law income to which they are entitled.

(a) Implications if tax law income exceeds trust law income

3.5 Under this approach, a beneficiary who is "presently entitled" to trust law income may be required under s 97(1) of the 1936 Act to include in their assessable income an amount of net income which is greater than the amount of trust law income to which they are entitled, and to which has been paid or distributed to them.

3.6 That is, they may be subject to tax on amounts whish they will not receive, and are not entitled to actually receive.

3.7 This outcome seems to be contrary to the objectives of Division 6 of the 1936 Act as outlined by Emmett J in the Full Court of the Federal Court decision in *Bamford v Federal Commissioner of Taxation* (2009) 176 FCR 250 (discussed above).

(b) Implications if trust law income exceeds tax law income

3.8 However, where the net income of a trust estate for the purposes of s 95(1) of the 1936 Act is less than the trust law income, then a beneficiary who is "presently entitled" pursuant to s 97(1) of the 1936 Act will be required to include in their assessable income an amount which is less than the trust law income to which they will be entitled, and which will be paid to them.

3.9 As a result, an on the assumption that the beneficiaries are "presently entitled" to the whole of the trust law income, with the result that the whole of the "net income" of the

trust estate is included in their assessable income pursuant to s 97(1) of the 1936 Act, there can be no part of the net income to which ss 99 or 99A of the 1936 Act applies.

3.10 There is still a question as to whether, in these circumstances, the beneficiary must include the excess amount (i.e. the amount not included under s 97(1) of the 1936 Act) under some provision of the tax acts (e.g. CGT event E4 as contained in s 104-70 of the 1997 Act).

The quantum approach

3.11 The quantum approach (which is no longer good law) is based on the proposition that a beneficiary can only be presently entitled to such amount(s) of trust income as they actually receive.

3.12 Further, any part of the net income of the trust estate which exceeds the amount to which the beneficiary is presently entitled is not income to which the beneficiary is presently entitled to pursuant to s 97 of the 1936 Act, with the result that the trustee is subject to tax on it under s 99A of the 1936 Act (unless the Commissioner exercises it discretion to cause it to be subject to tax under s 99).

3.13 As with the proportionate approach, where the net income of the trust estate for s 95(1) of the 1936 Act purposes is less than the trust law income, such that the beneficiary receives an amount which is greater than the amount included in their assessable income, the question arises as to how the excess is to be taxed (if at all).

4. Bamford

4.1 Bamford was a much anticipated decision. In the view of some[1] the decision was a missed opportunity to settle an area of the trust law and tax law that has been crying out for correction: *Bamford* at [17] citing Hill J in *Davis v Federal Commissioner of Taxation* (1989) 86 ALR 195 at 230.

Background to Bamford

4.2 Mr and Mrs Bamford were beneficiaries of a discretionary trust known as the Bamford Trust (the "**Trust**"). The trustee of the Trust was P&D Bamford Enterprises Pty Ltd. Mr and Mrs Bamford were also the directors and employees of P&D Bamford Enterprises Pty Ltd.

[1] Slater QC *Taxation Trust Income After* Bamfor'ds *Case*, 26th National TIA Convention, 2-4 March 2011

4.3 During the 2000 income tax year, the Trust made a contribution to an offshore superannuation fund on behalf of Mr and Mrs Bamford. The contribution was sourced from borrowings by the corporate trustee, in its capacity as trustee of the Trust.

4.4 For the purposes of determining the "net income" of the Trust for the 2000 income tax year, the corporate trustee (in its capacity as trustee of the Trust) claimed a deduction for both the contribution made to the offshore superannuation fund, and the interest on the borrowed funds used to make the contribution. The total deduction claimed was $191,701.

4.5 After taking into account of the deductions, the "net income" of the Trust for that year was distributed to specified beneficiaries of the Trust. Included in the distribution were Mr and Mrs Bamford, who both had specified amounts distributed to them.

4.6 Specifically, for that income tax year (i.e. the 2000 income tax year), the trustee of the Trust allocated amounts to certain beneficiaries of the Trust, including a payment of $34,000 each to Mr and Mrs Bamford. However, the trustee of the Trust did not have sufficient funds to pay the full amount of $34,000, and instead paid them $33,872, being what the trustee of the Trust thought was the total remaining trust funds.

4.7 The amount initially distributed by the trustee of the Trust was $187,530.

4.8 In 2005, the Commissioner of Taxation applied the anti-avoidance provisions so as to disallow the deductions of the Trust (for the 2000 income tax year) for the superannuation contribution and the interest. As a result of the denial of the deductions, for the purposes of the 2000 income tax year the Trust's taxable income exceeded its accounting income.

4.9 The decision essentially dealt with two things:

4.9.1 whether the 'proportionate approach' applied in the event that tax law income exceeds accounting / trust income; and

4.9.2 whether the trust deed of the trust could characterise an amount of capital gains as income of the Trust.

Application of the proportionate view

4.10 As a result of the denial of the deduction, the Trust's taxable income increased by $191,000. The Commissioner issued amended income tax assessments to both Mr and Mrs Bamford. Pursuant to the assessments, the Commissioner contended that Mr and Mrs Bamford were liable to tax on the increased 'net income' of the Trust based on the proportionate share of the amount by which the taxable income of the trust exceeded the accounting income.

4.11 Indeed, the Commissioner sought to assess Mr and Mrs Bamford on an extra $34,624, on the basis that that amount represented the 'share' of the additional $191,000 as their share (i.e. 18%) of the previous amount (i.e. $187,530) actually distributed.

4.12 However, the taxpayers argued that they should only be taxed on the difference between the $33,872 which they actually received, and the specific amount of $34,000 which was originally allocated to them (i.e. an amount of $128 each).

4.13 The High Court rejected the taxpayer's argument, and in doing so applied the "proportionate approach".

4.14 The High Court took a two step approach in dealing with this issue:

4.14.1 First – the High Court held that the term "*… income of the trust estate …*" as contained in s 97(1) of the 1936 Act refers to distributable income, being income as determined by the trustee taking into account the terms of the trust (e.g. the trust deed) and appropriate accounting principles.

4.14.2 Secondly – after ascertaining the "share" of the distributable income to which a beneficiary is presently entitled, s 97(1) of the 1936 Act then requires that "*… that share of the net income of the trust estate …*" be ascertained, being the shares of the taxable income and not the distributable income.

4.15 Further, it was held that the inclusion within s 97(1) of the 1936 Act of the defined phrase "*… net income of the trust estate …*" and the undefined term "*… the income of …* [the] *… trust estate …*" indicated that these were intended to have different meanings. As a result, the term "*… the income of …* [the] *… trust estate* " had a different and defined meaning for taxation purposes.

4.16 The Court at [45] held that the analysis of Sundberg J in *Zeta Force Pty Ltd v Commissioner of Taxation* (1998) 84 FCR 70 at 74-75 should be applied:

> *The resolution of the second issue of construction is to be found in the analysis by Sundberg J in* Zeta Force Pty Ltd v Commissioner of Taxation *… . His Honour dealt with the first issue of construction to the same effect as that just explained, saying:*
>
> > *"The words 'income of the trust estate' in the opening part of s 97(1) refer to distributable income, that is to say income ascertained by the trustee according to appropriate accounting principles and the trust instrument. That the words have this meaning is confirmed by the use elsewhere in Div 6 of the contrasting expression 'net income of the trust estate'. The beneficiary's 'share' is his share of the distributable income."*
>
> *Sundberg J then continued:*
>
> > *"Having identified the share of the distributable income to which the beneficiary is presently entitled, s97(1) requires one to ascertain 'that share of the net income of the trust estate'. That share is included in the beneficiary's assessable income. The expression 'net income of the trust estate' in par (a)(i) has the meaning given it by s 95(1) – taxable income as opposed to distributable income. The words 'that share' in par (a)(i) refer*

back to the word 'share' in the expression 'a share of the income of the trust estate', and indicate that the same share is to be applied to an income amount calculated according to a different formula (taxable income as opposed to distributable income). Since the income amount may differ according to which formula is applied, the natural meaning to give to 'share' where it appears for the second time is 'proportion' rather than 'part' or 'portion'. When Parliament wanted to convey the latter meaning, as it did in ss 99 and 99A, it used the word 'part'.

The contrast between the expressions 'share of the income of the trust estate' and 'that share of the net income of the trust estate' shows that the draftsman has sought to relate the concept of present entitlement to distributable income, and not to taxable income, which is, after all, an artificial tax amount. Once the share of the distributable income to which the beneficiary is presently entitled is worked out, the notion of present entitlement has served its purpose, and the beneficiary is to be taxed on that share (or proportion) of the taxable income of the trust estate."

4.17 For the 2000 income year, the "net income" of the Trust included the amount of $191,701 which should not have been claimed as a deduction in the tax return of the Trust. As a result, the High Court held that the assessable income of Mr and Mrs Bamford should include a share of that amount, equivalent to the share they each received of the distributable income.

Whether the trust deed could re-characterise amounts

4.18 The trust deed of the Trust gave the trustee the discretion to determine whether a particular receipt should be treated as income or capital.

4.19 The trustee relied on this power to pass a resolution to distribute the first $60,000 of net income, "*… including …* [the] *…. capital gain …*" to Mr and Mrs Bamford in equal shares.

4.20 The Commissioner argued that the capital gain was not income of the Trust. Further, since there was no income, no beneficiary could be 'presently entitled' to the amount in question, the trustee of the Trust should be assessed at the special rates.

4.21 The High Court held that the term "income" as contained in s 99A of the 1936 Act should be interpreted as income of the trust estate, as understood in trust law.

4.22 As a result, the net capital gain of the Trust became the income of the Trust after the trustee exercised its discretion to characterise the capital gain as income of the Trust.

Outcome for Trust Distributions

4.23 There is no room for doubt that Bamford establishes that:

4.23.1 income of the trust estate identified in s 97(1) of 1936 Act is to be determined according to any directions set out in the Trust Deed;

4.23.2 the share of the net income attributable to a beneficiary is to be determined in the same proportions in which the beneficiary enjoys the present entitlement to the share of the income of the trust.

4.24 In this first regard, the Court made it clear that the general rules regarding apportionment between capital and income of receipts and outgoings was largely based on assumptions which could be displaced by the terms of the trust instrument: Bamford at [17]. The general law of trusts operates to give meaning to the term "the income of the trust estate".

4.25 The determination of present entitlement to a share of the income is a process of trust administration. The decision of the Full Court of the Federal Court in *C of T v Totledge Pty Ltd* (1982) 40 ALR 385 at 393 is quoted in support: Bamford at [39]. The High Court distinguished its own decision in *C of T v Australia and New Zealand Savings Bank Ltd* (1998) HCA 53 (Bamford at [39]) as not relevantly addressing the issue. Finally, the Court observed that the Commissioner's lack of consistency in wishing to exclude "statutory income" from "income of the trust estate" did not assist his argument that "income" means "income according to ordinary concepts": Bamford at [41].

4.26 On the meaning of the term "share of the net income" the High Court adopted the proportionate approach advocated by Sunberg J in *Zeta Force* (discussed above).

4.27 What does this translate into for trustees making decisions in respect of trust distributions for the 2010 income year?

4.28 There are a number of relevant observations to be made.

4.29 First, if the Trust Deed provides a formula for determining the income of the trust then that formula will determine the entitlement of the beneficiaries to income. If, for example, the Deed contains words to the following effect:

> *"The net income of the trust is an amount equal to the amount determined in accordance with subsection 95(1) of the* Income Tax Assessment Act 1936 *but reduced by any amount which would otherwise be included by application of Division 207 of the* Income Tax Assessment Act 1997*".*

4.30 Throughout this paper "subsection 95(1) terms" means an amount adjusted for the franking credit gross up. The issue of grossing up is considered below in the context of using the full tax exemption including the franking rebate available to children.

4.31 Leaving aside the elimination of any gross up for franking credits (which itself is affected by the Streaming Amendments as discussed below) the amount of net income for trust law purposes

will equal the tax law income. The two will coincide so that there should, in the ordinary course, be no amount assessable to the trustee under s 99A of the 1936 Act.

4.32 Secondly, if the Trust Deed is silent then "ordinary income" principles apply. Just what they are is difficult to say. The ATO has expressed the view that income of a trust is income according to ordinary principles. This is not the same thing as accounting income determined in accordance with accounting principles. It requires a dissection of receipts into:

4.32.1 income according to ordinary principles;

4.32.2 income which is not ordinary income;

4.32.3 capital receipts.

4.33 Following that dissection, the expenses must be apportioned accordingly.

4.34 This is, of course, all too much. Many trust deeds will have a clause like that in Bamford which allows the trustee to determine whether a receipt is capital or income. Others will have very broad powers allowing the trustee to determine the basis on which income of the trust is to be worked out.

4.35 If these powers exist they should be used to avoid uncertainty brought about by the "ordinary income" approach. If they do not exist then the deed should be to give the trustee such a power. Whether such an amendment will amount to a resettlement, which might have adverse capital gains tax (and stamp duty) consequences, is discussed at **paragraphs xx** below.

4.36 Thirdly, because the proportionate approach has prevailed, a strict application of that rule will mean that great care needs to be taken when seeking to direct a specific amount of tax law net income to a particular beneficiary with absolute certainty e.g. the maximum amount to a child which escapes the punitive rates under Division 6AA of the 1936 Act. This issue is illustrated in the Examples which follow.

4.37 Fourthly, the High Court decision says nothing about streaming of trust income. The matter was not in issue. The uncertainty about streaming of income according to its character remained unabated, until the Streaming Amendments.

4.38 Finally, the ATO has done away with the benevolent "capital beneficiary" approach set out in Practice Statement PSLA 2005/1 (GA) on and from 13 October 2010.

Examples

4.39 The best way to illustrate these points is by way of example. In the examples which follow the following facts apply in relation to the A Family Trust for the income year ended 30 June 2010:

Receipts:

rent	$50,000
net capital gain	$100,000

Expenses:

rental expenses	$10,000
interest	$20,000

4.40 The interest relates to the rental property only. The discountable capital gain was made on the sale of shares in a listed company. The intended beneficiaries are Mr and Mrs A and their two children both under 18.

4.41 Because of the low income rebate the following no-tax thresholds apply to minors:

Income Year end 30 June	**$**
2010	3,000
2011	3,333

4.42 If the income constitutes fully franked dividends the cash payment thresholds and grossed up taxable income amounts are:

Income Year end 30 June	**$ cash**	**$ taxable income**
2010	6,300	9,000
2011	7,000	10,000

4.43 These figures have considerable significance for trustees seeking to hit the no tax "sweet spot" for a distribution to a child.

(a) Subsection 95(1) terms apply – no "balance approach"

4.44 The taxable capital gain is $50,000. Accordingly, the distributable trust income is $70,000.

4.45 For 2010 a minor may be distributed $3,000 with no tax liability if entitled to the low income rebate (see comments above).

4.46 The trust distribution minutes might give effect to the following:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000

70,000

4.47 The tax law results will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.48 The cash in the trust will include the $50,000 covered by the 50% general CGT discount. This is not income and can be dealt with as capital. As this is a discretionary trust it can be distributed without tax consequences.

(b) Ordinary income applies – no "balance approach"

4.49 In this instance the trust distribution minutes will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	7,000
Mr A	7,000
	20,000

4.50 The tax law results will be:

	$
Child 1	$3{,}000 + {}^{3,000}/_{20,000} \times \$50{,}000$
Child 2	$3{,}000 + {}^{3,000}/_{20,000} \times \$50{,}000$
Mrs A	$7{,}000 + {}^{7,000}/_{20,000} \times \$50{,}000$
Mr A	$7{,}000 + {}^{7,000}/_{20,000} \times \$50{,}000$

4.51 The final results:

	$
Child 1	10,500
Child 2	10,500
Mrs A	24,500

Mr A	24,500
	70,000

4.52 This is a strict application of the proportionate approach.

4.53 Each of the children will pay tax on $7,500 at the Division 6AA punitive rates of 45%. This is not a good result.

(c) Subsection 95(1) applies – "balance approach" used

4.54 Trust minutes:

	$
Child 1	3,000
Child 2	3,000
Mrs A	half of the balance
Mr A	half of the balance

4.55 Trust income entitlements:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.56 The tax law result:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.57 This is the same outcome as where no "balance approach" is applied – but see below for the effect of a tax adjustment.

(d) Ordinary income applies – "balance approach" used

4.58 Trust minutes

	$
Child 1	3,000
Child 2	3,000
Mrs A	half of the balance
Mr A	half of the balance

4.59 Trust income created will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	7,000
Mr A	7,000
	20,000

4.60 The tax law results will be:

	$
Child 1	$3{,}000 + {}^{3,000}/_{20,000} \times \$50{,}000$
Child 2	$3{,}000 + {}^{3,000}/_{20,000} \times \$50{,}000$
Mrs A	$7{,}000 + {}^{7,000}/_{20,000} \times \$50{,}000$
Mr A	$7{,}000 + {}^{7,000}/_{20,000} \times \$50{,}000$

4.61 The final results:

	$
Child 1	10,500
Child 2	10,500
Mrs A	24,500
Mr A	24,500
	70,000

4.62 Again there is no difference. However, the "balance approach" is more realistic because it is unlikely that the trust income or tax law income will be known as at any 30 June. In reality these figures are not known until the accounts are drawn later in the calendar year.

(e) Tax Law Adjustments

4.63 It is often important to anticipate an adjustment to the trust's tax law income especially where there is something contentions going on.

4.64 As has been seen the tax law result will follow on a proportionate basis the entitlements to income created under the Deed. To test the outcome it is assumed in the above examples that the trustee failed to recognise $10,000 of rental income (say the trustee at first considered that the income was to be deferred until the 2011 income year) but was in fact wrong about this.

4.65 How do the various approaches deal with such an adjustment?

Example (a) – subsection 95(1) applies (but no "balance approach")

4.66 The trust law entitlements and tax law results were the same:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.67 The tax law adjustment will increase both the trust law entitlement and the tax law income by $10,000. The Trustee has not dealt with this $10,000 and, without an operative default beneficiary clause, it will be assessed to the Trustee under section 99A of the 1936 Act.

4.68 The trust law entitlements and tax law result will be:

	$
Child 1	3000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
Trustee	10,000
	80,000

4.69 However, if there is no streaming of the capital gain (with the effect that all beneficiaries are entitled to a proportionate part of the capital gain) that part of the capital gain reflected in the income to which no beneficiary is presently entitled will be grossed up for the loss of the 50% general CGT discount. Five eighths of the $10,000 adjustment assessed to the Trustee is capital gain. As a result the share of the net income assessable to the Trustee will be increased by $6,250.

4.70 The final result will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
Trustee	16,250
	86,250

4.71 This is a costly outcome.

Example (c) – subsection 95(1) but using a "balance approach".

4.72 The trust law entitlement and tax law result were the same.

	$
Child 1	3,000
Child 2	3,000
Mrs A	half of the balance
Mr A	half of the balance

4.73 The unadjusted result was:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.74 The adjusted trust law entitlement and tax law result will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000 + 5,000
Mr A	32,000 +5,000
	80,000

4.75 The "balance approach" together with adoption of s 95(1) terms directs all of the tax law result from an adjustment made by the ATO to the balance beneficiaries.

4.76 If the balance distribution has been used Mr and Mrs A will "enjoy" a further $5,000 of income entitlement (it now having been correctly determined) and a further $5,000 of tax law net income each. No amount will be assessed to the trustee.

4.77 There is an argument that the beneficiaries have not become presently entitled to the amount of the adjustment to the trust law net income as it was not ascertained at the end of the income year. In the writer's opinion the trust law net income was always the amount as correctly adjusted by the ATO. There was never any uncertainty about it. It is simply the case that the trustee and ATO had not properly determined the correct quantum of income.

4.78 In practical terms how have the Courts looked at the "balance approach"? It has not come up that often.

4.79 The decision of Cooper J in *BRK (Bris) Pty Ltd v C of T* [2001] FCA 164 might at first blush give cause for concern. There the Court considered the operation of the default beneficiary clause in the Trust Deed. The distributions had been:

1993 income year:

"Hendon Unit Trust 100%

and Resolved that should the Commissioner of Taxation disallow any amount as a deduction or include any amount in the assessable income of the Trust, such amount or amounts are to be deemed distributed on 30th June 1993 in the same proportions as listed above to the beneficiaries listed above".

1994 income year:

(a) The sum of $304,021.72 to Westside Commercial Centre Pty Ltd as trustee of the Hendon Unit Trust for its absolute benefit.

(b) The following sums to the following beneficiaries for their absolute respective benefits: NIL

(c) The Balance to Jessica Wagner and Bill Wagner equally between them for their absolute benefit.

1995 income year:

Hendon Unit Trust	*First $220,000*
Northbourne Trust	*Next $100,000*

Wilhelm J Wagner and Jessica O Wagner	*Remainder of balance equally*

4.80 The same "variation of income" clause as in 1993 applied in this year.

4.81 It would appear that the Trust Deed did not adopt subsection 95(1) terms and that income was ordinary income.

4.82 It was found that the Hendon Unit Trust was not an object of the Trust and the distribution of income to it failed. The default beneficiaries clause distributed income in default of appointment to the beneficiaries described in the Schedule to the Deed as tenants in common. This was the usual wide class of family objects.

4.83 The Court concluded that the default beneficiary clause did not operate as at 30 June because the trustee had a reasonable time after the end of the income year in which to decide to distributed or accumulate.

4.84 The question arose as to whether the balance clause in the 1994 and 1995 determinations operated to take the amounts which the Trustee had attempted to distribute to the Hendon Unit Trust to Mr and Mrs Wagner. It was concluded that this was not the effect of the distribution minute and, as a result, the Trustee was assessable under section 99A.

4.85 At [40] Cooper J concluded:

> *"In my judgment the submission is misconceived. In the 1994 income year the clear intention of the applicant was to appoint to Mr and Mrs Wagner only so much of the Trust income, if any, as exceeded $304,021.72 in addition to any income in excess of that amount in the event that the appointment to WCC should fail. The position is no different in respect of the 1995 year. The trustee purported to appoint discrete amounts of income to the Hendon Unit Trust as to the first $220,000 and to the Northbourne Trust as the next $100,000. Finally, as to any remainder after the application of the first $320,000 of income, that remainder was to be appointed to Mr and Mrs Wagner; they did not as a matter of construction or intention on the part of the trustee, take by default all of the income in the event of failure of the other two appointments."*

4.86 Rather than being a cause for concern about the "balance approach" the decision of Cooper J on this point supports its operation. The specific quantum entitlements fix the income (and tax where s 95(1) terms apply) at the amount specified in the Trustee's determination. If the gift fails it does not flow to the balance beneficiary but to the default beneficiary or, in the alternative, there is no such entitlement created, giving rise to a s 99A assessment to the trustee.

4.87 Further comfort can be obtained from observations made in *C of T v Ramsden* [2005] FCAFC 39. In that case the Court was concerned with the issue whether a beneficiary had effectively renounced a distribution of income.

4.88 The distribution minutes for the 1996 income year provided:

"Steve Hart Family Holdings No.2	*$17,295*
Steve Hart Family Holdings No.3	*$6,639*
Unlimited Aerobatic Discretionary Trust	*$34,810*
The Adcock Practice Trust	*$429,000*
Troy B Hart	*$4,750*
Steven I Hart	*The Balance"*

4.89 It was agreed that the Adcock Practice Trust did not qualify as a beneficiary. The default beneficiary clause provided for income which had not been appointed prior to year end to be held for Steven Hart and his three children as tenants in common. The ATO assessed each of the default beneficiaries to one quarter of the amount which had failed to be appointed to the Adcock Practice Trust.

4.90 The argument was pressed before the primary judge that the income should pass by way of the balance distribution to Steven Hart: Ramsden at [38] to [41]. Justice Spender's rejection of this argument was confirmed by the Full Court. It was observed at [2005] FCAFC 39 at [72]:

> *"We agree with this construction. 'The Balance' does not include the amounts which precede "The Balance" in the resolution of 30 June 1996.*
>
> *'The Balance' is the Income of the Trust for the year ended 30 June 1996 other than the amounts which precede it in the resolution in question, whether effectively appointed or not".*[2]

4.91 This observation supports the "balance approach" taken in this paper where there have been effective distributions. Note, however, that it will not work where a distribution is ineffective. In such a case the adjustment will be assessed to the default beneficiary, if there is one, or to the trustee.

Example (d) – Ordinary Income with balance approach applying

4.92 The trust law entitlements were:

	$
Child 1	3,000

[2] [2005] FCAFC 39 at para. 72.

Child 2	3,000
Mrs A	half of the balance
Mr A	half of the balance

4.93 Trust income entitlements:

	$
Child 1	3,000
Child 2	3,000
Mrs A	7,000
Mr A	7,000
	20,000

4.94 The tax law result was:

	$
Child 1	10,500
Child 2	10,500
Mrs A	24,500
Mr A	24,500
	70,000

4.95 When the tax law income is adjusted by $10,000 there is no change to the trust law result. The tax law result will be:

	$
Child 1	$10,500 + {}^{10,500}/_{70,000} \times \$10,000$
Child 2	$10,500 + {}^{10,500}/_{70,000} \times \$10,000$
Mrs A	$24,500 + {}^{24,500}/_{70,000} \times \$10,000$
Mr A	$24,500 + {}^{24,500}/_{70,000} \times \$10,000$

4.96 The final result will be:

	$
Child 1	12,000
Child 2	12,000
Mrs A	28,000
Mr A	28,000

	80,000

4.97 The result has only become worse from a Division 6AA income perspective.

Will a "default beneficiary" clause in the Deed assist?

4.98 An income default beneficiary clause would be expressed something like:

> *"If the Trustee has not determined to distribute all of the net income of the Trust by the end of the Income Year the Income Default Beneficiary will be absolutely entitled to that part of the net income which has not been distributed."*

4.99 The term "Income Default Beneficiary" will be appropriately defined to identify individuals or companies.

4.100 In Example (a) – subsection 95(1) terms but no "balance approach" – a default beneficiary clause would have deflected the tax adjustment from the trustee to the default beneficiary.

4.101 In Example (b) – ordinary income but no "balance approach" – the default beneficiary clause would have no effective operation as all of the trust law/tax law income has been accounted for.

4.102 The trust entitlements were:

	$
Child 1	3,000
Child 2	3,000
Mrs A	7,000
Mr A	7,000
	20,000

4.103 The tax law result was:

	$
Child 1	10,500
Child 2	10,500
Mrs A	24,500
Mr A	24,500
	70,000

4.104 If the tax law income is increased by $10,000 the trust law income does not alter. The tax law adjustment is apportioned according to the trust law income apportionments, as follows:

	$
Child 1	10,500 + $^{3,000}/_{20,000}$ x 10,000
Child 2	10,500 + $^{3,000}/_{20,000}$ x 10,000
Mrs A	24,500 + $^{7,000}/_{20,000}$ x 10,000
Mr A	24,500 + $^{7,000}/_{20,000}$ x 10,000[3]
	70,000

4.105 The final tax results will be:

	$
Child 1	12,000
Child 2	12,000
Mrs A	28,000
Mr A	28,000
	80,000

4.106 In Example (c) – subsection 95(1) terms and a "balance approach" – the default beneficiary clause has no role to play because the adjustment will always be directed to the balance beneficiary.

4.107 In Example (d) – ordinary income and "balance approach" – the default beneficiary clause has no need to operate because the tax adjustment will simply be apportioned in accordance with the trust law entitlements which don't change.

Summary re Tax Adjustments

Trust Accounting Basis	Tax Law Income	Trust Income	Adjustment to (if no default beneficiary)	Adjustment to (if there is a default beneficiary)
subsection 95(1) – no "balance approach"	+ $100	+ $100	Trustee	Default Beneficiary
subsection 95(1) – "balance approach"	+ $100	+ $100	Balance Beneficiaries	Balance Beneficiaries
ordinary income – no "balance approach"	+ $100	no change	All Beneficiaries	All Beneficiaries
ordinary income – "balance approach"	+ $100	no change	All Beneficiaries	All Beneficiaries

[3] The proportions remain the same whether the trust law or tax law results are used.

Guidance from Bamford

4.108 As the High Court observed in Bamford at [17]:

> *"… both sides in argument on the present appeals accepted that whichever of the competing constructions of Div 6 were accepted examples could readily be given of apparent unfairness in the resulting administration of the legislation"*

4.109 In reaching the conclusion that the terms of the Trust Deed determine the trust income to which a beneficiary may be made entitled the High Court has gone very far towards resolving most of the problems and uncertainties which confronted practitioners and the trustees and beneficiaries they advise. With a good understanding of the terms of the Trust Deed as they effect trust distributions most distribution problems can be addressed.

4.110 As has been demonstrated in the above worked examples adopting a s 95(1) terms plus "balance approach" achieves the following:

4.110.1 the quantum of tax distribution to children can be locked in.

4.110.2 any "normal" tax adjustment will flow to the balance beneficiaries.

4.110.3 if used in conjunction with a default beneficiary clause ineffective distributions can also be dealt with.

4.111 The subsection 95(1) but without a "balance approach" can lead to:

4.111.1 an assessment of the tax adjustments to the trustee under section 99A;

4.111.2 clawback of any general CGT discount.

4.112 This can be addressed by using a default beneficiary (of course the default beneficiary should not be a company where the general CGT discount is involved).

4.113 The balance approach together with a considered default beneficiary is to be preferred as the outcome is more predictable.

4.114 The ordinary income approach is problematic because it is:

4.114.1 too difficult to calculate what is net ordinary income;

4.114.2 and tax law adjustments will be spread across all beneficiaries (as there is no adjustment to the net income).

5. Div 7A Amendments

5.1 Division 7A of Part III of the 1936 Act deals with accessing wealth in private companies without accounting for the tax that would otherwise be payable on the value accessed. It focuses on three means of accessing wealth in private companies – payments from a private company, loans from a private company or the forgiveness of a debt by a private company to an associate of that company.

5.2 In 2010 there were two broad changes to the Division 7A interacts with trusts:

5.2.1 The Div 7A Amendments; and

5.2.2 The Commissioner's position in *Taxation Ruling 2010/3* and *Practice Statement Law Administration* 2010/4.

5.3 The changes to Division 7A include the insertion of an introductory note to Division 7A stating:

> An amount may also be included in the assessable income of a shareholder or shareholder's associate if:
>
> (a) a company has an unpaid present entitlement to income of a trust; and
>
> (b) the trustee makes a payment or loan to, or forgives a debt of, the shareholder or associate.
>
> (See Subdivisions EA and EB.)

5.4 This note is of interest as it strongly suggests that Subdivision EA is a 'code' which is intended to capture arrangements where there is an unpaid present entitlement subsisting between a trust and a corporate beneficiary and there is then a loan, payment or forgiveness that occurs between the trustee and a shareholder or an associate of a shareholder in the corporate beneficiary.

5.5 This should be contrasted with the position in the ATO *Taxation Ruling* 2010/3 where the ATO assert that subdivision EA has much more limited effect, where they generally restrict its operation to the situation where there is a sub-trust in existence between a trustee and a corporate beneficiary and there is then loan, payment or forgiveness involving a shareholder or an associate of a shareholder and the trustee of the sub-trust.

5.6 In the 31 March 2010 NTLG meeting the professional bodies questioned the ATO as to whether the introduction of this provision into Division 7A cast doubt on the position in their draft ruling. The meeting agenda includes the following discussion:

> The ATO does not see a conflict between the legislation of provisions dealing with unpaid present entitlements and the position set out in Draft Ruling TR 2009/D8.

This is because, contrary to the premise of the question, under Draft Ruling TR 2009/D8 unpaid present entitlements will retain that status for Division 7A purposes in many situations, including where:

- the amount representing the UPE is physically held on sub-trust for the sole benefit of the private company beneficiary;
- the amount representing the UPE is being used by the trustee but all benefits from this use are held for the sole benefit of the private company; or
- the private company beneficiary is not aware and cannot be taken to be aware that the funds representing its UPE are being used for the potential benefit of any or all discretionary objects of the trust (rather than being physically set aside or used for its sole benefit).

The ATO has appropriately consulted with Treasury prior to and during the drafting of TR 2009/D8.

Provisions within Division 7A dealing with unpaid present entitlements will continue to have their intended application and there is no inconsistency between the Exposure Draft legislation and the draft Ruling.

Use of assets

5.7 As was announced in the 2009/10 Federal Budget the use of assets owned by private companies, or owned by trusts where there is a present entitlement owing to a private company may be subject to tax after 1 July 2009.

5.8 The way in which the use of assets will become subject to tax is through the amendment of the definition of the term 'payment' in Division 7A so that it extends to the provision of an asset (other than a transfer of property) for use by an entity. Consistent with the present operation of Division 7A the provision of the asset will only result in Division 7A consequences where the asset is provided to a shareholder or associate of a shareholder.

5.9 For the purposes of Division 7A the payment will occur when the use of the asset occurs.

5.10 A payment will also arise however where the asset is not used, but is available for use. The examples in the EM are illustrative of when it will be the right to use the asset, and not its use, that is subject to the Division 7A rules.

> ***Example (right to use from EM)***
> ***Brian is a shareholder of a private company that owns a luxury yacht. He does not have a formal agreement with the company in relation to the yacht, however, he takes the yacht out every second weekend.***
>
> ***Brian keeps the yacht at the company's business premises, but takes the key home. Brian stores several personal items on the yacht.***
>
> ***Brian's fortnightly use of the yacht is a payment under Division 7A. The availability of the yacht for Brian's use is also subject to Division 7A because the yacht is not readily available for use by the company. The company would need to arrange with Brian to***

get the key and for the removal of Brian's personal items before using the yacht. That is, the asset is available for Brian's use to the exclusion of the company.

Example (use from EM)
Marina is a shareholder of a private company that owns a city apartment. The apartment is generally available for rent. However, Marina asks the company not to rent the apartment out for a week so that she and her family can use the apartment over a long weekend. Marina's use of the apartment is a payment for the purposes of section 109CA.

5.11 An issue that arose on consultation over the draft legislation giving effect to these changes was whether the mere availability of assets to a shareholder or associate would result in the shareholder or associate being treated as having the asset available for their use. The EM again includes an example where there a payment is not taken to arise where an asset is available as a result of a general entitlement to use an asset without actual use of the asset.

Example (mere entitlement from EM)
Peter is a shareholder of a private company that owns five cars for company use. Shareholders and their associates have general permission to use the cars on weekends if they are not being used for company business. Peter regularly takes one of the cars home.

Peter's use of the car that he takes home will be subject to Division 7A. This will include driving the car (actual use) and the availability of the car for his use to the exclusion of the company, such as when it is parked at home, or at a restaurant that Peter is visiting.

Although Peter may have general permission to use all five of the cars, he does not use all of them for the purposes of Division 7A. The four cars that Peter leaves at the company premises are available for the company to loan to another shareholder, employee, customer, or other party. That is, these cars are not available to Peter to the exclusion of the company.

5.12 The EM also includes examples of where an asset is available to more than one shareholder or associate and it is necessary to determine who is taxed. The EM suggests and apportionment of the taxable value to the person who is the real recipient of the benefit. One example sets out that a minor that benefits should not be taken to receive a Division 7A payment, where another sets out that incidental use by a spouse of a vehicle provided to a shareholder would not result in the spouse being taxed on the benefit provided.

5.13 In valuing the payment taken to be made it will be the amount that would have been paid for the use of the asset in an arm's length dealing less any consideration paid that will be determined to be the payment for Division 7A purposes.

5.14 There are a number of exceptions from the payment provisions applying, including one not previously announced dealing with residential property:

5.14.1 Minor benefits – if the provision of the asset would have been a minor benefit under section 58P of the FBTAA had it been provided to an employee then the benefit will be disregarded for Division 7A purposes

5.14.2 Otherwise deductible payments – if a once off deduction would have been available to the shareholder or their associate in connection with the use of the asset then there will be no benefit to be taken into account for Division 7A purposes.

5.14.3 Dwellings – the use of a dwelling can be exempt where the following conditions are satisfied:

5.14.3.1 the entity or their associate is carrying on a business;

5.14.3.2 the entity or their associate uses or is granted or has a lease, licence or other right to use land, water or a building for the purpose of carrying on the business; and

5.14.3.3 the provision of the dwelling to the entity is connected with that use or with that lease, licence or other right to use the land, water or building to carry on the business.

5.14.4 Main residences – the provision of a dwelling that is a person's main residence does not result in a Division 7A payment where:

5.14.4.1 The provider of the dwelling is a private company;

5.14.4.2 The private company acquired the dwelling before 1 July 2009; and

5.14.4.3 The private company would pass COT from the time that the dwelling was acquired until the end of the time that a payment could be taken to be made under Division 7A.

5.14.5 Vacant land – if the exception for a dwelling or a main residence applies, it will extend to adjacent land in the same way as occurs in the main residence exemption.

Corporate limited partnerships

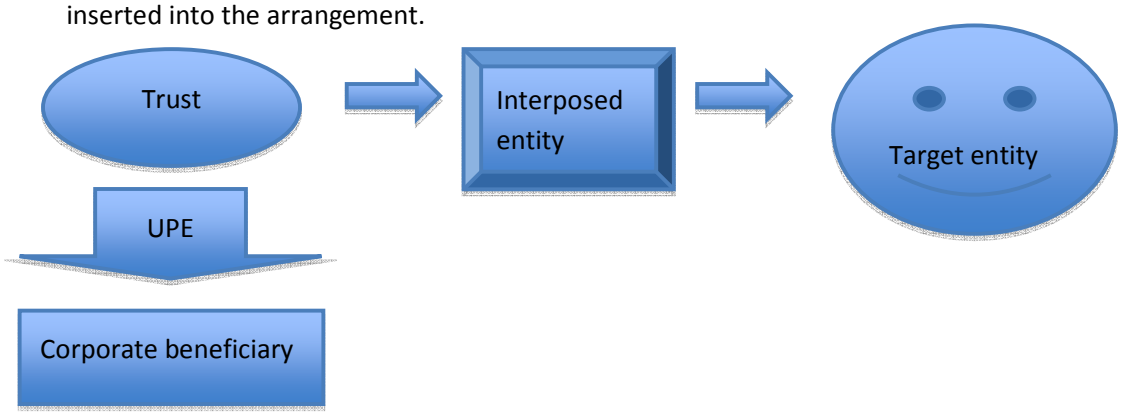
5.15 Closely held corporate limited partnerships (limited liability partnerships) will also now be subject to Division 7A. A corporate limited partnership will be closely held where it has fewer than 50 members or where an entity has, directly or indirectly, for the entity's own benefit, an entitlement to 75% or more of the income and capital of the partnership.

Interposed entities

5.16 The Div 7A Amendments fix two drafting issues in relation to the use of interposed entities.

5.17 The Division 7A legislation as originally drafted allowed for a payment by a private company through an interposed entity to be treated as a payment for Division 7A purposes.

5.18 The legislation did not however on a plain reading, allow for a trust where there was an unpaid present entitlement, to be deemed to have made a payment where an interposed entity was inserted into the arrangement.



5.19 A payment from the trust through an interposed entity to a target entity will now be caught by Division 7A if a reasonable person would consider that a loan or payment made to the interposed entity was made to enable a loan or payment to be made by the interposed entity to the target entity.

5.20 Consistent with the current operation of Subdivision EA however, a payment through to the target entity will only result in a Division 7A deemed dividend if it is referable to a reduction in a present entitlement that is in itself attributable to an unrealised gain in the trust.

5.21 The Div 7A Amendments also ensures that where an unpaid present entitlement is owed to a company by a trust, but the loan, payment or forgiveness that occurs does not involve the trust that owes the unpaid present entitlement, that Subdivision EA still has effect.

5.22 Subdivision EA will apply to treat a loan or payment from a trust as being a Division 7A loan or payment to the extent that the loan or payment is referable to an unpaid present entitlement owed to a private company where that amount has not already resulted in a Division 7A loan or payment.

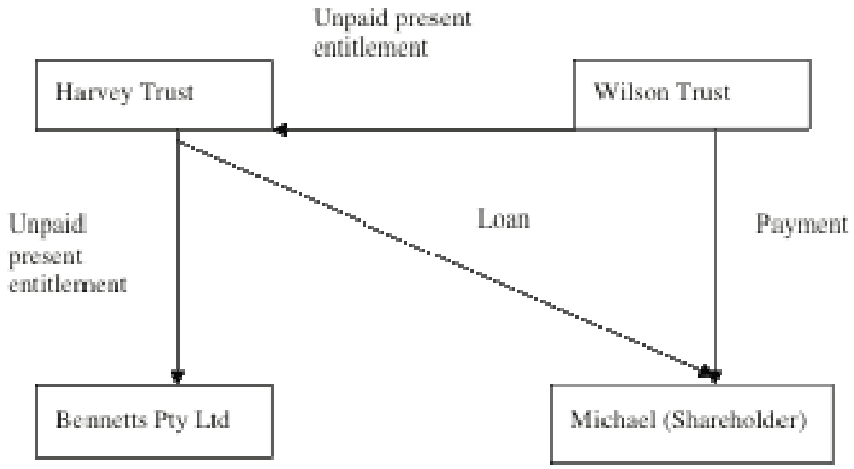
Example (interposed trust from EM)
Michael is a shareholder of Bennetts Pty Ltd and Bennetts Pty Ltd is a beneficiary of Harvey Trust. In the 2009-10 income year, Michael receives a payment from the trustee of the Wilson Trust, which is attributable to an unrealised gain. He receives this payment

because of his shareholding in Bennetts Pty Ltd. Michael also receives a $2,000 non-compliant Division 7A loan from the Harvey Trust.

Bennetts Pty Ltd is not presently entitled to an amount from the net income of the Wilson Trust. However, Bennetts Pty Ltd is entitled to $10,000 from the net income of the Harvey Trust (the first interposed trust) and Harvey Trust is presently entitled to $10,000 from the net income of the Wilson Trust. These amounts remain unpaid.

The loan made by the Harvey Trust to Michael will be included in Michael's assessable income under ordinary operation of subsection 109XA(2).

Bennetts Pty Ltd is taken to be presently entitled to $8,000 from the Wilson Trust, which is the unpaid present entitlement of $10,000 from the Harvey Trust, reduced by the $2,000 loan amount that is included in Michael's assessable income under another provision of Subdivision EA.



Loan back arrangements

5.23 Subdivision EA as currently drafted only captures payment arrangements where the payment is a reduction of a present entitlement that is referrable to an unrealised gain.

5.24 To circumvent these rules, apparently it had been suggested that the following arrangement could be entered into:

5.24.1 An unpaid present entitlement exists to a private company, say of $100,000.

5.24.2 A payment is made by the trustee of the trust to a beneficiary of an amount far in excess of the UPE, for example $1 million.

5.24.3 The amount in excess of the UPE is then loaned back to the trustee, being $900,000.

5.24.4 Thus, the beneficiary now has a credit loan of $900,000.

5.24.5 In future years the trustee appoints income to the company and uses the funds to repay the credit loan.

5.25 The need for there to be a payment referrable to a reduction of an unrealised gain will be removed where the payment made to a beneficiary is in reduction of a loan made on or after 1 July 2009 where a reasonable person would conclude that the trustee obtained the loan in order to make the payment.

Amendment to distributable surplus definition

5.26 The definition of distributable surplus will be amended so that amounts that have been deemed to be dividends as a result of the operation of Subdivision EA will be removed from the distributable surplus (by being correctly included as non-commercial loans).

Forgiveness of 109XB loans

5.27 There is a drafting problem that will be rectified so that the forgiveness of a loan by a trustee that has already been deemed to be a dividend will not result in a subsequent dividend. The law already applies in this way to the forgiveness of a debt owed to a private company by a shareholder that has already been deemed to receive a dividend under Division 7A.

Dividend set-off

5.28 Another drafting problem dealing with dividend set-offs will also be rectified.

5.29 At present, where a private company makes a loan that is deemed to be a dividend and later pays an unfranked dividend that is set off against that loan the later dividend is not included in assessable income.

5.30 The ability to disregard the later dividend does not apply where the loan was made by the trustee of a trust and where the deemed dividend arose under section 109XB.

5.31 The ability to disregard a later unfranked dividend offset against a loan from a trustee is being introduced.

Setting off employment entitlements

5.32 Another unusual aspect of the interaction of Division 7A generally and Subdivision EA has been that employment related payments that are offset against loans by trustees do not count as repayments if there is a borrowing of a similar or greater amount to the amount repaid. This is in contrast to setting off such a payment against a loan by a company where the repayment is taken into account even if there is a further borrowing.

5.33 This anomaly is to be rectified.

Borrowing to repay

5.34 Under the previous law a repayment is disregarded where the repayment is made where a reasonable person would conclude the repayment was made in order to borrow a similar or greater amount. This prevents a person from borrowing funds during a financial year, repaying on 30 June, and then reborrowing the amount on 1 July.

5.35 While the law has operated in this way (with some exceptions for repayments that occur by way of offsetting assessable amounts such as the wages noted above) it arguably has not operated where, instead of repaying to borrow, a person borrows to repay. This was be remedied so that a borrowing to repay will also activate section 109R.

> ***Example (from EM)***
> ***Alicia obtains a loan of $10,000 from Cleary Pty Ltd. Alicia has until the lodgment day to repay the loan. Two weeks before the lodgment day Alicia obtains a further $10,000 from Cleary Pty Ltd. She then repays the original $10,000 loan a week before the lodgment day.***
>
> ***The repayment of the original $10,000 loan is not a repayment for the purposes of section 109D, because Alicia has borrowed a similar amount from Cleary Pty Ltd and in this case a reasonable person would conclude that the loan was obtained in order to make the repayment of the original $10,000.***
>
> ***The original $10,000 loan is treated as a deemed dividend subject to the distributable surplus of the private company.***

Adding back payments for Division 7A purposes

6. Streaming

6.1 The paper will no consider the importance of, and ability to, stream as it stood before the Streaming Amendments. Then it will consider the Streaming Amendments.

Pre-Streaming Amendments

6.2 As can be seen from the illustrations above the ability to stream income according to its character is very important. This is particularly the case for franked dividends and capital gains but there are other forms of income with tax characteristics that may also be important e.g. income from a foreign source, income which has been subject to TFN withholding tax.

6.3 The decisions in Bamford tell us nothing about streaming income for tax purposes.

6.4 Most modern trust deeds will give the trustee power to distinguish between classes of income and to characterise a particular amount of income as having been derived from a particular source. The Deed should also allow the trustee to allocate expenses to the different classes of income.

6.5 The law regarding streaming after the decision in *CPT Custodian Pty Ltd v Commissioner of State Revenue [2005] HCA 53* ("**CPT Custodian**") was quite uncertain. The decision of the High Court in *Charles v C of T [1954] HCA 16* ("**Charles**") has always been the centre of gravity of the character flow through approach. The decision in Charles was heavily criticised by the Court in CPT Custodian. The question is whether that criticism went to the maintenance of character or is restricted to the characterisation of the interest in the trust fund by looking through to the underlying assets.

6.6 The decision of the High Court in CPT Custodian, in the writers' views, stands for the proposition that a beneficiary has an equitable interest in the residue of the trust fund after the Trustee's indemnity has been satisfied. This residue is characterless, whether it be income or capital, as the trustee may at any time satisfy its right to be indemnified from the receipts (which themselves have character).

6.7 Notwithstanding these problems the ATO has consistently taken the view that the character of the income in the hands of the beneficiary is taken from the character of the receipts of the Trustee[4] even after taking into account the decision in *CPT Custodian*[5].

6.8 In the non-binding ruling IT2328 (now withdrawn) it was observed:

> *"For income tax purposes where a beneficiary in a trust estate is presently entitled to the net income or a share of the net income of the trust estate, that income as a general principle has the same character in the hands of the beneficiary as it had in the hands of the trustee."*

6.9 The most significant streaming issues concern capital gains and dividends. In the case of capital gains Division 115 of Part 3-1 of the 1997 Act proceeds on an implication that income entitlements will take on at least some part of the character of the capital gains derived by the trustee. There is no clear legislative follow through. The guidance found in Sesction 115-200 of the 1997 Act establishes the implied maintenance of character:

> *"This Subdivision sets out rules for dealing with the net income of a trust that has a net capital gain. The rules treat parts of the net income attributable to the trust's net capital gain as capital gains made by the beneficiary entitled to those parts."*

[4] see in particular ATO ID 2008/51 dealing with Division 13.3A of the SIS Regulations.

[5] see Taxation Ruling STR 92/13, IT2328, IT2512, IT2004 (withdrawn) and ATO ID 2007/108 (which is concerned with foreign sourced income and in respect of which subsection 6B(2A) of the 1936 Act also comes into consideration).

6.10 Subsection 115-215(1) is the nub of the provisions:

> *"The purpose of this section is to ensure that appropriate amounts of the trust estate's net income attributable to the trust estate's capital gains are treated as a beneficiary's capital gains when assessing the beneficiary, so:*
>
> *(a) the beneficiary can apply capital losses against gains; and*
>
> *(b) the beneficiary can apply the appropriate discount percentage (if any) to gains."*

6.11 The process is described as attribution rather than maintenance of source character. This may be the necessary distinction to make the rules work. There is, however, no guidance about how the attribution is to be carried out.

6.12 What is clear is that if there is no trust income to which the beneficiary is presently entitled there can be no attribution. This is a major issue where there is no trading income but there are capital gains in the Trust. Use of s 95(1) terms to describe income overcomes this problem and makes the case for attribution much clearer. The capital gain (or at least 50% of it) will be included in the income. The connection for Subdivision 115-C purposes is very clear.

6.13 The ATO has had to resort to the artificiality of the "capital beneficiary approach" in PS LA 2005/1 (GA) to achieve this sensible outcome – but this practice statement was withdrawn following Bamford.

6.14 The issues with streaming can be readily appreciated in the context of capital gains and the 50% general CGT discount. The streaming issue is, of course, the denial of the 50% CGT general discount when a trust to company distribution is in play.

6.15 Maintaining the example used above in which there is a net capital gain of $100,000, and gross rental income of $50,0000 and net rental income of $20,000.

6.16 In this instance the trustee wishes to cause the capital gain to be assessed in the hands of an individual (say Mrs A) and the net rental income in the hands of a company, A Co. If it is assumed that the Trust Deed has all of the usual income characterisation and streaming provisions and the Deed adopts subsection 95(1) terms, the outcome readily appears.

6.17 The income entitlements are:

	$	
A Co	20,000	comprising net rental income
Mrs A	50,000	comprising the capital gain
	70,000	

6.18 If the ATO took the view that streaming was unobtainable the outcome would be:

	$	$ Total
A Co	5,714 + taxable capital gain $28,572	34,286
Mrs A	50,000	50,000
		84,286

6.19 The other area of concern is franking credits. At least there is a ruling on this aspect of streaming, *Taxation Ruling* 92/13 (repealed as of 22 June 2011 because of the Streaming Amendments). The provisions of Subdivision 207-B and in particular ss 207-45 to 207-57 are consistent with flow through of the franked character of a dividend.

6.20 The fact the Example set out immediately below s 207-35(3) of the 1997 Act depends on character maintenance. It is worthwhile setting this Example out in full:

> *"A franked distribution of $70 is made to the trustee of a trust in an income year. The trust also has $100 of assessable income from other sources. Under subsection (1) the trust's assessable income includes an additional amount of $30 (which is the franking credit on the distribution). The trust has a net income of $200 for that income year.*
>
> *There are 2 beneficiaries of the trust, P and Q, who are presently entitled to the trust's income. Under the trust deed, P is entitled to all of the franked distribution and Q is entitled to all other income.*
>
> *The distribution flows indirectly to P (as P is entitled to a share of that net income and has a 100% share of the distribution under section 207-55). P therefore has an amount of assessable income that is equal to its share of the distribution. Under this subsection, P's assessable income also includes the full amount of the franking credit (as P's share of the franking credit on the distribution is $30 under section 207-57). Q's share of the net income therefore does not include any of the franking credit."*

6.21 Clearly the legislation contemplates maintenance of character for the purposes of dividend imputation.

Commissioner's Concern of Division 6 Abuses

6.22 As usual the ATO is driven by the possibility that the decision in Bamford might support some abuse and revenue loss. No matter that their interpretations lead to massive headaches for practitioners.

6.23 This much is exampled by several examples set out *in Practice Statement PS LA 2009/7* which was released prior to the decision in Bamford.

6.24 Examples 1 and 5 in particular show what the ATO is on about.

6.25 Example 1 concerns the trustee of a family trust deriving $250,000 in income during the income year and applying that income to the purchase of a holiday home. The trustee, acting in accordance with a power expressed in the terms of the Trust Deed to do so, determines that the expenditure on the purchase of the house is an outgoing on income account with the effect that the trust law income available for distribution is $5,000. One of the beneficiaries has tax losses.

6.26 The trustee distributes the $5,000 trust law income to the loss beneficiary. The losses cover the tax law income which follows the trust law income to the loss beneficiary.

6.27 The ATO expresses concern about the mismatch of the actual amount to which the beneficiary becomes entitled ($5,000) and the amount of the tax law income flowing to the beneficiary ($250,000) and the tax not paid because of the losses.

6.28 It is difficult to say why this is of concern to them. The true effect of the transaction is to maintain $245,000 in the capital of the trust. The same tax effect would be obtained by distributing all of the $250,000 to the loss beneficiary. There is no tax difference in this illustration. It is unlikely there would be a tax benefit for the purposes of Part IVA. The most likely explanation for the transaction is the financial risk the loss beneficiary has been exposed to. If the beneficiary became entitled to call on the trustee to pay him or her $250,000 the creditors may be able to stake a claim to that amount. It is a neat and sensible piece of asset protection planning.

6.29 Example 5 is about a trust which has distinct income and capital beneficiaries. The trustee has a power to determine whether receipts and outgoings are on income or capital account. The Trust Deed is amended to admit a tax exempt entity as a beneficiary.

6.30 The trust derives $100,000 of income (meaning income according to ordinary concepts) during the income year. The trustee determines that $95,000 of that amount is a capital receipt. The remaining $5,000 is the trust law income according to the Trust Deed. This amount is appointed to the tax exempt beneficiary. All of the tax law income will be assessed to the charity. It would follow that the trustee makes a capital distribution of the $95,000 to a family beneficiary.

6.31 The ATO observe in the Practice Statement that Part IVA might apply in the circumstances. In the writer's view it almost certainly would do so in particular because of the amendment to introduce the tax exempt charity as a beneficiary and the fact that prior year distributions had been made only to family members. A much more challenging (and perhaps more realistic) illustration would arise if the tax exempt charity was already an object and the trustee had made distributions to charities in the past. The Part IVA case in such circumstances would be difficult to make out. This is an example of the acknowledged "apparent unfairness in the resulting administration of the legislation" as noted by the High Court in Bamford at [17].

6.32 The ATO apparently accept that Bamford authorizes characterization of capital receipts as income for the purposes of the Deed but are not so ready to accept that ordinary income may be recharacterised as capital (as in Example 5). They appear to be fortified in this by observations made by the Full Court of the Federal Court in *Forrest v C of T* [2010] FCAFC 6 ("**Forrest**").

6.33 The relevant question before the Court there was whether Mr Forrest was entitled to a deduction for interest he had incurred in relation to funds he had borrowed to acquire units in a unit trust. The outcome turned on whether there was a fixed income component to which the funds related. The Full Court concluded that a power to determine whether any amount received by the trustee was on revenue account or capital account (clause 12 of the Deed) was not a power to change the beneficiaries' rights. In so doing they observed at [11]-[12]:

> *'In our opinion, the power conferred by cl. 12 cannot be exercised by the trustee wrongly to classify a receipt as a capital gain, when the receipt is, in truth, income, and thus deprive the appellant of his interest in the unit component of the trust. Clause 12 is not an unlimited power to be exercised in the trustee's unconfined discretion….*
>
> *Clause 12.2(a) is a power to determine how a distribution to beneficiaries is classified. That limited power is not a power which is capable of altering the beneficiaries' rights. Clause 12 is to be read consistently with the balance of the Trust Deed and an appreciation that it contains various powers of an administrative character. The words used can be given full force honestly to classify income or distributions according to law, as the appellant contended to this Court".*

6.34 It is very difficult to know how far this goes. The issue in Forrest was about whether or not the exercise of the power changed the rights as between classes of beneficiaries. Presumably the ATO would say that the exercise of the power in a case like that in Example 5 was not an "honest" classification of the receipt as capital. Hopefully the issue will not arise very often.

Point of Interest

6.35 A case of interest is *Greenhatch v FCT* [2011] AATA 479 that ostensibly concerned superannuation contributions where the answer to the superannuation question was determined by construing streaming through a trust. The case of is interest for two reasons.

6.36 First, the AAT went out of their way to note the Commissioner's interpretation of Bamford was wrong. At [49] and [50] they said:

> *Much, if not all, of the Commissioner's case turns on his rejection of any underlying conduit theory and his interpretation of the implications of the decision in Bamford.*

The Commissioner's contention that the conduit theory has no role to play is based on foundations with which we do not agree. Accordingly, those foundations do not support the conclusion he seeks to draw.

6.37 Secondly, in relation to Subdivision 207-B of the 1997 Act, being the franking credits provisions, the AAT observed at [63]:

> *Section 207-35 of the 1997 Act has an aspect that makes the conclusion [that] amounts passing through trusts to beneficiaries thereof carry the character and identity that they had in the hands of the trustee more compelling. That section includes an example that contemplates differential distributions in determining the taxation burdens that are imposed on the beneficiaries of the trust.*

6.38 Question: was it necessary to introduce the Streaming Amendments in light of the above comments? Given we have the Streaming Amendments it is of academic interest only.

Streaming Amendments

6.39 The *Tax Laws Amendment (2011 Measures No. 5) Act* 2011 (Cth) was introduced into parliament (as a Bill) on 2 June 2011, was passed unamended and assented to on 29 June 2011. They take effect from 1 July 2010. These dates show how close a call it was as the Streaming Amendments are critical for trustee decisions that were needed to be made on 30 June 2011 – one day after their royal assent.

6.40 Subject to a statement by the Commissioner – extending the time a trustee could make decisions to 31 August 2011, which has anyway passed, but the writers question the Commissioner's ability to alter what trust law[6] requires to be done on 30 June of any year – the Streaming Amendments apply to trustees resolving to deal with trust income and capital gains.

6.41 From the 2011 income year and thereafter taxable capital gains and franked distributions are dealt with under these rules.

6.42 The Streaming Amendments operate by diverting from Division 6 of the 1936 Act the franked distributions and taxable capital gains. They are assessed directly in the hands of the beneficiaries who are presently entitled to them. They do this via Subdivision 207-B of the 1997 Act for franked distributions and via Subdivision 115-C of the 1997 Act for taxable capital gains. However, for the taxable capital gains they must still pass through the method statement in s 102-5(1) of the 1997 Act.

[6] *Trustees of the Estate Mortgage Fighting Fund Trust v FCT* [2000] FCA 981 per Hill J; *Case R105,* 84 ATC 692; *Antonopoulos v FCT* [2011] AATA 431.

6.43 The Streaming Amendments have introduced a new Division 6E into Part III of the 1936 Act to prevent double taxation. It adjusts the Division 6 income and net income of the trust to take out the amounts to which the beneficiary has been made specifically entitled.

6.44 It can be seen that the specific entitlement of the beneficiary or beneficiaries is the critical aspect of the Streaming Amendments. This is required to determine tax liability.

Specific Entitlement

6.45 The notion of a specific entitlement conceals the difficulties of applying the Streaming Amendments to all trusts, be they discretionary, fixed, unit, et cetera. The mechanism by which you become specifically entitled are set out in the relevant Subdivisions: s 115-228 for capital gains and s 207-58 for franked distributions. The provisions seem substantially similar at first look but there are some significant differences.

6.46 A beneficiary is specifically entitled under s 207-58 of the 1997 Act to an amount of a franked distribution made by the trust equal to the amount calculated under the following formula

$$\text{Franked Distribution} \times \frac{\text{Share of net financial benefit}}{\text{Net financial benefit}}$$

6.47 The "net financial benefit" is an amount equal to the financial benefit referable to the franked distribution (after an application by the trustee of expenses that are directly relevant to the franked distribution).

6.48 The term "financial benefit" is already in s 995-1 f the 1997 Act. It means anything of economic value, even if the transaction also imposes an obligation on the entity. Benefits and obligations are to be looked at separately and not set off against each other, but it is the net financial benefit to which the formula looks.

6.49 The "share of the financial benefit" is the amount of the financial benefit referable to the franked distribution specifically linked to the particular beneficiary. The share of the net financial benefit is:

> *… an amount equal to the *financial benefit that, in accordance with the terms of the trust:*
>
> *a. the beneficiary has received, or can be reasonably expected to receive, and*
>
> *b. is referable to the *franked distribution (after application by the trustee of any expenses that are directly relevant to the franked distribution) and*
>
> *c. is recorded, in its character as referable to the franked distribution, in the accounts or records of the trust no later than the end of the income year.*

6.50 Section 115-228 is identical to the discussion above of franked distributions, subject to:

6.50.1 the financial benefit must be referable to the capital gain "after application by the trustee of any losses, to the extent that the application is consistent with the application of capital losses against the capital gain in accordance with the method statement in subsection 102-5(1)"; and

6.50.2 the recording of the financial benefit must be "no later than 2 months after the end of the income year."

Complexities and Going Forward

6.51 An issue to be mindful of is – in fact an issue of significant importance – is that a trust with no "income", which was one of the problems in the Bamford appeals, will not be able to stream franking credits. This will mean that where the franked distributions, together with other ordinary income, is insufficient to more than offset expenses of the trust the franking credits cannot go through to the beneficiaries. The same restriction does not apply in relation to capital gains streamed through the trust.

6.52 Ken Schurgott FTIA, in his paper in the August 2011 *Taxation in Australia* titled "Trust streaming 2011" notes a number of complications that arise from the Streaming Amendments:

> *As will be seen, there are a number of issues which emerge that complicate the legislation over and beyond the rather simple approach adopted prior to the Commissioner's stance on streaming. The things which complicate matters are:*
>
> *a. There can be different outcomes according to the definition of income adopted by the trust deed;*
>
> *b. Significantly different outcomes can result where a beneficiary has not been made specifically entitled to the franked distribution or capital gain. This is most pronounced in relation to capital gains;*
>
> *c. The concept of making a beneficiary entitled to the entire financial benefit from a capital gain or franked distribution is fraught with difficulty, particularly where there are capital losses or directly related expenses; and*
>
> *d. The way in which capital losses and directly related expenses are to be dealt with is confusing.*

6.53 It can be seen from these further issues, and the problem of actually apply what is a simple concept of diverting the amounts to Subdivisions 115-C and 207-B respectively, are anything but straightforward or settled. Indeed, a senior council on the writer's floor, after having advised on

the Streaming Amendments is of the view that this is where future archeologists will find the bones of 21st Century tax lawyers and accountants.

7. Changes to the taxation of trusts – terms to be provided for in a trust document

7.1 Given the changes in the taxation of trusts, it is recommended that trust deed (or any other constituent documents) be reviewed so as to determine:

7.1.1 How income, capital gains and outgoings are accounted for and determined; and

7.1.2 How income, capital gains and outgoings are to be distributed.

7.2 Some of the powers which may be advantageous to have within a trust instrument include:

7.2.1 an accounting policy which is sufficiently broad and allows the trustee to exercise maximum discretion;

7.2.2 the discretion to reclassify and allocate income and capital gains;

7.2.3 the discretion to reclassify and allocate outgoings;

7.2.4 the discretion not to recoup losses (whether income or capital in nature);

7.2.5 the ability to allocate and stream classes of income and capital and their related tax attributes;

7.2.6 and ensure that any unpaid present entitlement / loan provisions are removed, and an ability to hold amounts subject to a sub-trust.

7.3 Some additional powers to be considered include:

7.3.1 whether the trustee has the power to distribute income and / or capital at any time within a tax year;

7.3.2 whether any determination of income (or capital) can be made within the income tax year; and

7.3.3 whether the trustee has a power to determine entitlements with respect to an income tax year after the relevant year.

Accounting policy

7.4 Essential is ensuring that the trust deed provides guidance with respect to an accounting policy that should be used by the trustee. Such an accounting policy should provide sufficient flexibility for the trustee, so that it may depart from generally accepted accounting standards in the event that the trustee considers that it is appropriate to do so.

Reclassifying and allocating income and capital

7.5 As the High Court in *Bamford* accepted that the tax law income of a trust is dependent upon (amongst other things) the definition of that term in the trust deed, regard should be given to the definition of the 'income' as contained in the trusts constituent documents.

7.6 An issue to consider is whether attributed amounts (e.g. franking credits) should be included within the definition of trust income. An issue that arises is that if attributions are included in trust income (and which are not physically 'paid' by a trustee – but which follow certain amounts of income), whether by being included in trust income, and thereby providing that a trustee creates a 'present entitlement' in a beneficiary to an amount that is never received by a trustee, the trustee will be exposed to a claim in relation to amounts that are not actually received by the trustee.

7.7 It is submitted that amounts such as franking credits should be prima facie carved-out of the definition of income. However, the definition should contain discretionary elements to allow a trustee to cause such 'attributed' amounts to fall within the definition of income.

7.8 An approach which may be considered is, in defining trust income:

7.8.1 Provide that it prima facie equals the amount provided for in s 95(1) of the 1936 Act (less any franking credits);

7.8.2 If the tax law approach is not warranted for a particular tax period, then:

7.8.2.1 According to an accounting policy adopted by the trustee; or

7.8.2.2 Any other basis as determined by the trustee; or

7.8.3 In the trustee's absolute discretion, the gross income of the trust.

Reclassifying and allocating outgoings

7.9 In *Cajkusic v FC of T (No 2)* (2006) ATC 4752 ("**Cajkusic**") deductions allowable to a family discretionary trust for payments that were made under an employee benefits trust arrangement in the income tax years ending 30 June 1997 and 30 June 2008 caused there to be a loss within the trust estate.

7.10 As a result of the losses, there was no distributable income of the trust. As a result, the Full Court of the Federal Court held that the lack of distributable income meant that there could be no beneficiary of the trust (for the relevant income tax years) to be "*… presently entitled …*'"pursuant to s 97 of the 1936 Act to any amount.

7.11 It should be noted that the Commissioner's subsequent application for special leave to appeal to the High Court was rejected.

7.12 Cajkusic stands for the proposition that the 'distributable income' of a trust is determined by reference to proper accounting principles, as well as the terms of a trust deed. In this context distributable income is income determined according to accounting principles, and which is distributable amongst the beneficiaries. It does not alter either the income as calculated under accounting principles, of the 'net income' as determined under s 95(1) of the 1936 Act – rather, only gives a trustee the power to determine the distributable amounts.

7.13 As a result of the decision in Cajkusic, it is submitted that a trust deed should give a trustee the power to reclassify, and allocate outgoings, so that there can be 'distributable income' to which beneficiaries are presently entitled.

Discretion not to recoup losses (whether income or capital in nature)

7.14 It is recommended that a trustee have a discretion not to recoup losses (whether of an income or capital nature). That is, a power not to recoup losses which have arisen in the past.

8. Resettlement considerations

8.1 Whenever the terms of a trust are varied, an issue to consider is whether the variation amounts to a 'resettlement'.

8.2 Resettlements relate to changes to a trust relationship which have the effect that a new trust estate comes into existence. According to the High Court in *FC of T v Commercial Nominees of Australia Ltd* [2001] HCA 33 (***"*Commercial Nominees"**), the issue to determine is whether '*… what occurred* … [i.e. the variation] … *was a fundamental alteration in the trust relationship*

established by the original deed, such that it destroyed the necessary continuity of the 'taxpayer'…'.

8.3 A resettlement can have significant income tax, capital gains tax (**'CGT'**) and stamp duty consequences, including that:

8.3.1 the trust property may be disposed of, potentially triggering both stamp duty and CGT liabilities;

8.3.2 carried forward tax benefits may be lost; and

8.3.3 beneficiaries may dispose of their interests in the original trust and acquire interest in a new trust.

8.4 Specifically in the context of CGT, a resettlement may cause either CGT event E1 (s 104-60 of the 1997 Act) or CGT event E2 (s 104-65 of the 1997 Act) to happen.

8.5 In August 2001 the issued a Statement of Principles entitled *Creation of a new trust* (the **"Statement**"). The Statement clarifies when, in the Commissioner's view, changes to a trust gives rise to a new trust. The Commissioner considers that a new trust estate arises where there is a 'fundamental change to a trust relationship' – ie, a change in the essential nature and character of the original trust relationship. Further, the Commissioner considers that a new trust (i.e. a resettlement) may arise in the following circumstances:

- a change in beneficial interest in trust property;
- a new class of beneficial interest (whether introduced or altered);
- a redefinition of the beneficiary class;
- changes in the terms of the trust or the rights or obligations of the trustee;
- changes in the nature of the trust property;
- additions of property which could amount to a new and separate settlement;
- depletion of trust property;
- a change in the termination date of the trust;
- a change in the trust that is not contemplated by the terms of the original trust;

- a change in the essential nature and purpose of the trust; and / or
- a merger of two or more trusts or a splitting of the trust.

8.6 The Commissioner considers that depending on their nature and extent, the above changes may either amount to:

8.6.1 a variation of a continuing trust; or

8.6.2 a fundamental change in the essential nature and character of the trust relationship. In such a case, the original trust may be brought to an end and a new trust created. Whether a new trust is created depends on the terms of the original trust and on the powers of the trustee.

8.7 The High Court in Commercial Nominees held that significant changes to a superannuation fund trust deed did not create a new trust, even though the amending deed had:

8.7.1 changed the name of, and appointed a new trustee to the fund;

8.7.2 introduced a new category of beneficiaries;

8.7.3 changed the fund from a defined benefit fund to an accumulation fund;

8.7.4 appointed a professional management company as administrator; and

8.7.5 allowed membership to be promoted to the public.

8.8 The High Court in *Commercial Nominees* considered that there were three main indicators of the continuity of a trust relationship, being:

8.8.1 the constitution of the trust;

8.8.2 the trust property; and

8.8.3 the membership of the trust.

8.9 Substantial changes any of the above may cause a resettlement.

8.10 The High Court considered that, in order to destroy the necessary continuity, changes in one or more of the above indicators must be such as to terminate the existence of the entity, or to produce the result that the particular trust does not derive the income in question. It was held that the changes made to the trust deed in question were not sufficient to destroy the continuity, primarily because the fund was at all times governed by the same deed, the trust property did not change, and the members before the amendment to the trust deed remained members afterwards. We consider that the amendments discussed above will not cause a resettlement.

8.11 The Commissioner notes in the Statement that administrative changes, such as re-defining trust income (without more) may not cause a resettlement (depending on the context) as it may be administrative in nature.

8.12 However, regard will need to be given to the implications to the membership (i.e. the beneficial entitlements) of the trust, and what implications such an amendment will have on the respective entitlements in a trust. For example, an important consideration will be determining how unallocated / undistributed income is to be dealt with. For example, is such income:

8.12.1 accumulated, and form part of the corpus of the relevant trust estate;

8.12.2 is it distributed to certain default beneficiaries; or

8.12.3 is it held on trust for a specific purpose (e.g. a charitable purpose).

Changes in the Taxation of Trusts

A paper presented by Michael Bennett and Denis Barlin at the NSW Young Lawyers CLE

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Michael Bennett E bennett@sevenwentworth.com.au D 8224 3055 M 0408 029 416
Denis Barlin E dbarlin@wenworthchambers.com.au D 9231 6646 M 0404 848 311

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1. General overview

1.1 The income years ended 30 June 2010 and, more particularly, 30 June 2011 have been very active for the taxation of trusts. Significant events in three areas of trust taxplay activity:

1.1.1 decisions of the Courts and principally the High Court's decision in *Commissioner of Taxation v Bamford* (2010) 240 CLR 481; (2010) 264 ALR 436; [2010] HCA 10 ("**Bamford**");

1.1.2 legislative changes, principally:

1.1.2.1 the new rules set out in *Tax Laws Amendment (2011 Measures No. 5) Act* 2011 (Cth) (the "**Streaming Amendments**") that deal with taxation of franking credits and capital gains in trusts; and

1.1.2.2 the new rules set out in the *Tax Laws Amendment (2010 Measures No. 2) Act* 2010 (Cth) that are principally about Division 7A of Part III of the *Income Tax Assessment Act* 1936 (Cth) (the "**1936 Act**") and companies providing rights to use property, but also contain some trust issues (the "**Div 7A Amendments**"); and

1.1.3 Australian Taxation Office ("**ATO**") activities principally the very controversial draft ruling on unpaid present entitlements, TR 2009/D8.

1.2 Some of these changes have overtaken themselves. For instance, there was at the time – and this paper includes – a discussion of streaming post Bamford (see **heading 4** below). That discussion should be read as having been overtaken by the Streaming Amendments (see **heading 5**).

1.3 And what's more the change is not over. Chapter 2 of the explanatory memorandum to the Bill that introduced the Steaming Amendments makes it clear that the streaming provisions have been introduced as an interim measure to deal with perceived anomalies in the taxation of capital gains and franked distributions pending a comprehensive review of Division 6 of Part II of the 1936 Act.

1.4 The changes made so far give rise to issues themselves and further consequential issues for trusts. In addressing the issues – both outlined above and the consequential issues – this paper will discuss:

1.4.1 Taxation of trusts generally;

1.4.2 The competing views before Bamford;

1.4.3 The context of Bamford and what it means for trusts;

1.4.4 Briefly (as it is not germane to the other issues raised in the paper) what are the Div 7A Amendments and what they mean for trusts;

1.4.5 What are the Steaming Amendments and what they mean for trust;

1.4.6 What a trust deed needs in light of those three issues; and

1.4.7 Amending trust deeds to deal with those three issues.

1.5 The issues are dealt with in this order as they are chronological to their occurring.

2. Taxation of Trusts

2.1 The provisions dealing with the taxation of trust income are contained in Division 6 of Part III of the 1936 Act (which comprises of sections 95 to 102).

2.2 As a result of the enactment of Streaming Amendments, regard should also be given to:

2.2.1 Subdivision 207-B of the *Income Tax Assessment Act* 1997 (Cth) (the "**1997 Act**") – which deals with franking credits obtained by a trust estate; and

2.2.2 Subdivision 115-C of the 1997 Act – which deals with the distribution of capital gains by a trust estate.

2.3 Chief Justice Latham in *Tindal v FC of T* (1946) 72 CLR 608 at 618 observed that the object of Division 6 of the 1936 Act is to "*… secure payment of tax upon the whole of the net income of a trust estate, either from a beneficiary or the trustee, whether the income is paid over to or on account of the beneficiary …*". Further, according to Emmett J in *Bamford v Federal Commissioner of Taxation* (2009) 176 FCR 250 "*… an important assumption underlying Division 6 …* [is] *… that a beneficiary who derives a share of the net income should be in a position to pay out of that income; otherwise, the beneficiary could be placed in a difficult position*."

2.4 The starting point in determining the taxation of trust income is s 97 of the 1936 Act. Relevantly, s 97(1) of the 1936 Act 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; and

(b) the exempt income of the beneficiary shall include:

(i) so much of the individual interest of the beneficiary in the exempt income of the trust estate as is attributable to a period when the beneficiary was a resident; and

(ii) so much of the individual interest of the beneficiary in the exempt 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;

except to the extent to which the exempt income to which that individual interest relates was taken into account in calculating the net income of the trust estate; and

(c) the non-assessable non-exempt income of the beneficiary shall include:

(i) so much of the individual interest of the beneficiary in the non-assessable non-exempt income of the trust estate as is attributable to a period when the beneficiary was a resident; and

(ii) so much of the individual interest of the beneficiary in the non-assessable non-exempt 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]

2.5 That is, s 97 of the 1936 Act provides that where a beneficiary, who is not under a legal disability is presently entitled to a "*… share of the income of the trust estate …*", the assessable income of:

2.5.1 a resident beneficiary includes the beneficiary's share of the '*… net income of the trust estate …*'; and

2.5.2 a non-resident beneficiary includes so much of the beneficiary's share of the net income of the trust as is attributable to sources in Australia.

2.6 It should be noted that the term "net income of the trust estate" for the purposes of s 97 of the 1936 Act is defined in s 95(1) of the 1936 Act. However, the term "*… the income of the trust estate …*" as contained in s 97 of the 1936 Act is not defined in the 1936 Act.

2.7 Subsection 95(1) of the 1936 Act defines the term 'net income', in relation to a trust estate as:

> ***net income**, 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 Division 393 of the Income Tax Assessment Act 1997 (Farm management deposits) 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.*

2.8 For completeness, it should be noted that:

2.8.1 s 98 of the 1936 Act provides that the trustee is liable to tax on behalf of a beneficiary where the beneficiary is presently entitled to a share of the income of a trust estate, but the beneficiary is under a legal disability;

2.8.2 ss 99 and 99A of the 1936 Act apply to subject the trustee to tax where there is some part of the net income of a trust estate that is not subject to tax under either of ss 97 or 98 of the 1936 Act. The difference as between s 99 and s 99A of the 1936 Act is the rate of tax applicable. Typically, the trustee will be subject to tax under section 99A of the 1936 Act at a penal rate of tax equal to the maximum rate of tax (currently 45%). However, the Commissioner has a discretion to apply s 99 of the 1936 Act in certain circumstances, in which case the trustee will be subject to tax at the normal marginal rates of tax.

3. The two competing views before the decision in Bamford

3.1 There has been, for some time, two competing views in the taxation of trust income – the proportionate view and the quantum view.

Proportionate approach

3.2 *David & Anor v FC of T* 89 ATC 4377 contains an example of the application of the proportionate approach (which according to the High Court's decision in Bamford, is the correct approach).

3.3 The proportionate view looks to the share (or proportion) of trust law income of a trust to which a beneficiary is "presently entitled", and then applies that share or proportion to the net income of a trust estate to calculate how much of the net income is to be included in the beneficiary's assessable income.

3.4 As an example, if a beneficiary is entitled to one half of the trust law income, then the beneficiary must include half of the net income in their assessable income – irrespective of whether it is more or less than the amount of the trust law income to which they are entitled.

(a) Implications if tax law income exceeds trust law income

3.5 Under this approach, a beneficiary who is "presently entitled" to trust law income may be required under s 97(1) of the 1936 Act to include in their assessable income an amount of net income which is greater than the amount of trust law income to which they are entitled, and to which has been paid or distributed to them.

3.6 That is, they may be subject to tax on amounts whish they will not receive, and are not entitled to actually receive.

3.7 This outcome seems to be contrary to the objectives of Division 6 of the 1936 Act as outlined by Emmett J in the Full Court of the Federal Court decision in *Bamford v Federal Commissioner of Taxation* (2009) 176 FCR 250 (discussed above).

(b) Implications if trust law income exceeds tax law income

3.8 However, where the net income of a trust estate for the purposes of s 95(1) of the 1936 Act is less than the trust law income, then a beneficiary who is "presently entitled" pursuant to s 97(1) of the 1936 Act will be required to include in their assessable income an amount which is less than the trust law income to which they will be entitled, and which will be paid to them.

3.9 As a result, an on the assumption that the beneficiaries are "presently entitled" to the whole of the trust law income, with the result that the whole of the "net income" of the

trust estate is included in their assessable income pursuant to s 97(1) of the 1936 Act, there can be no part of the net income to which ss 99 or 99A of the 1936 Act applies.

3.10 There is still a question as to whether, in these circumstances, the beneficiary must include the excess amount (i.e. the amount not included under s 97(1) of the 1936 Act) under some provision of the tax acts (e.g. CGT event E4 as contained in s 104-70 of the 1997 Act).

The quantum approach

3.11 The quantum approach (which is no longer good law) is based on the proposition that a beneficiary can only be presently entitled to such amount(s) of trust income as they actually receive.

3.12 Further, any part of the net income of the trust estate which exceeds the amount to which the beneficiary is presently entitled is not income to which the beneficiary is presently entitled to pursuant to s 97 of the 1936 Act, with the result that the trustee is subject to tax on it under s 99A of the 1936 Act (unless the Commissioner exercises it discretion to cause it to be subject to tax under s 99).

3.13 As with the proportionate approach, where the net income of the trust estate for s 95(1) of the 1936 Act purposes is less than the trust law income, such that the beneficiary receives an amount which is greater than the amount included in their assessable income, the question arises as to how the excess is to be taxed (if at all).

4. Bamford

4.1 Bamford was a much anticipated decision. In the view of some[1] the decision was a missed opportunity to settle an area of the trust law and tax law that has been crying out for correction: *Bamford* at [17] citing Hill J in *Davis v Federal Commissioner of Taxation* (1989) 86 ALR 195 at 230.

Background to Bamford

4.2 Mr and Mrs Bamford were beneficiaries of a discretionary trust known as the Bamford Trust (the "**Trust**"). The trustee of the Trust was P&D Bamford Enterprises Pty Ltd. Mr and Mrs Bamford were also the directors and employees of P&D Bamford Enterprises Pty Ltd.

[1] Slater QC *Taxation Trust Income After* Bamfor'ds *Case*, 26th National TIA Convention, 2-4 March 2011

4.3 During the 2000 income tax year, the Trust made a contribution to an offshore superannuation fund on behalf of Mr and Mrs Bamford. The contribution was sourced from borrowings by the corporate trustee, in its capacity as trustee of the Trust.

4.4 For the purposes of determining the "net income" of the Trust for the 2000 income tax year, the corporate trustee (in its capacity as trustee of the Trust) claimed a deduction for both the contribution made to the offshore superannuation fund, and the interest on the borrowed funds used to make the contribution. The total deduction claimed was $191,701.

4.5 After taking into account of the deductions, the "net income" of the Trust for that year was distributed to specified beneficiaries of the Trust. Included in the distribution were Mr and Mrs Bamford, who both had specified amounts distributed to them.

4.6 Specifically, for that income tax year (i.e. the 2000 income tax year), the trustee of the Trust allocated amounts to certain beneficiaries of the Trust, including a payment of $34,000 each to Mr and Mrs Bamford. However, the trustee of the Trust did not have sufficient funds to pay the full amount of $34,000, and instead paid them $33,872, being what the trustee of the Trust thought was the total remaining trust funds.

4.7 The amount initially distributed by the trustee of the Trust was $187,530.

4.8 In 2005, the Commissioner of Taxation applied the anti-avoidance provisions so as to disallow the deductions of the Trust (for the 2000 income tax year) for the superannuation contribution and the interest. As a result of the denial of the deductions, for the purposes of the 2000 income tax year the Trust's taxable income exceeded its accounting income.

4.9 The decision essentially dealt with two things:

4.9.1 whether the 'proportionate approach' applied in the event that tax law income exceeds accounting / trust income; and

4.9.2 whether the trust deed of the trust could characterise an amount of capital gains as income of the Trust.

Application of the proportionate view

4.10 As a result of the denial of the deduction, the Trust's taxable income increased by $191,000. The Commissioner issued amended income tax assessments to both Mr and Mrs Bamford. Pursuant to the assessments, the Commissioner contended that Mr and Mrs Bamford were liable to tax on the increased 'net income' of the Trust based on the proportionate share of the amount by which the taxable income of the trust exceeded the accounting income.

4.11 Indeed, the Commissioner sought to assess Mr and Mrs Bamford on an extra $34,624, on the basis that that amount represented the 'share' of the additional $191,000 as their share (i.e. 18%) of the previous amount (i.e. $187,530) actually distributed.

4.12 However, the taxpayers argued that they should only be taxed on the difference between the $33,872 which they actually received, and the specific amount of $34,000 which was originally allocated to them (i.e. an amount of $128 each).

4.13 The High Court rejected the taxpayer's argument, and in doing so applied the "proportionate approach".

4.14 The High Court took a two step approach in dealing with this issue:

4.14.1 First – the High Court held that the term "*… income of the trust estate …*" as contained in s 97(1) of the 1936 Act refers to distributable income, being income as determined by the trustee taking into account the terms of the trust (e.g. the trust deed) and appropriate accounting principles.

4.14.2 Secondly – after ascertaining the "share" of the distributable income to which a beneficiary is presently entitled, s 97(1) of the 1936 Act then requires that "*… that share of the net income of the trust estate …*" be ascertained, being the shares of the taxable income and not the distributable income.

4.15 Further, it was held that the inclusion within s 97(1) of the 1936 Act of the defined phrase "*… net income of the trust estate …*" and the undefined term "*… the income of …* [the] *… trust estate …*" indicated that these were intended to have different meanings. As a result, the term "*… the income of …* [the] *… trust estate* " had a different and defined meaning for taxation purposes.

4.16 The Court at [45] held that the analysis of Sundberg J in *Zeta Force Pty Ltd v Commissioner of Taxation* (1998) 84 FCR 70 at 74-75 should be applied:

> *The resolution of the second issue of construction is to be found in the analysis by Sundberg J in* Zeta Force Pty Ltd v Commissioner of Taxation *… . His Honour dealt with the first issue of construction to the same effect as that just explained, saying:*
>
> > *"The words 'income of the trust estate' in the opening part of s 97(1) refer to distributable income, that is to say income ascertained by the trustee according to appropriate accounting principles and the trust instrument. That the words have this meaning is confirmed by the use elsewhere in Div 6 of the contrasting expression 'net income of the trust estate'. The beneficiary's 'share' is his share of the distributable income."*
>
> *Sundberg J then continued:*
>
> > *"Having identified the share of the distributable income to which the beneficiary is presently entitled, s97(1) requires one to ascertain 'that share of the net income of the trust estate'. That share is included in the beneficiary's assessable income. The expression 'net income of the trust estate' in par (a)(i) has the meaning given it by s 95(1) – taxable income as opposed to distributable income. The words 'that share' in par (a)(i) refer*

back to the word 'share' in the expression 'a share of the income of the trust estate', and indicate that the same share is to be applied to an income amount calculated according to a different formula (taxable income as opposed to distributable income). Since the income amount may differ according to which formula is applied, the natural meaning to give to 'share' where it appears for the second time is 'proportion' rather than 'part' or 'portion'. When Parliament wanted to convey the latter meaning, as it did in ss 99 and 99A, it used the word 'part'.

The contrast between the expressions 'share of the income of the trust estate' and 'that share of the net income of the trust estate' shows that the draftsman has sought to relate the concept of present entitlement to distributable income, and not to taxable income, which is, after all, an artificial tax amount. Once the share of the distributable income to which the beneficiary is presently entitled is worked out, the notion of present entitlement has served its purpose, and the beneficiary is to be taxed on that share (or proportion) of the taxable income of the trust estate."

4.17 For the 2000 income year, the "net income" of the Trust included the amount of $191,701 which should not have been claimed as a deduction in the tax return of the Trust. As a result, the High Court held that the assessable income of Mr and Mrs Bamford should include a share of that amount, equivalent to the share they each received of the distributable income.

Whether the trust deed could re-characterise amounts

4.18 The trust deed of the Trust gave the trustee the discretion to determine whether a particular receipt should be treated as income or capital.

4.19 The trustee relied on this power to pass a resolution to distribute the first $60,000 of net income, "*… including …* [the] *…. capital gain …*" to Mr and Mrs Bamford in equal shares.

4.20 The Commissioner argued that the capital gain was not income of the Trust. Further, since there was no income, no beneficiary could be 'presently entitled' to the amount in question, the trustee of the Trust should be assessed at the special rates.

4.21 The High Court held that the term "income" as contained in s 99A of the 1936 Act should be interpreted as income of the trust estate, as understood in trust law.

4.22 As a result, the net capital gain of the Trust became the income of the Trust after the trustee exercised its discretion to characterise the capital gain as income of the Trust.

Outcome for Trust Distributions

4.23 There is no room for doubt that Bamford establishes that:

4.23.1 income of the trust estate identified in s 97(1) of 1936 Act is to be determined according to any directions set out in the Trust Deed;

4.23.2 the share of the net income attributable to a beneficiary is to be determined in the same proportions in which the beneficiary enjoys the present entitlement to the share of the income of the trust.

4.24 In this first regard, the Court made it clear that the general rules regarding apportionment between capital and income of receipts and outgoings was largely based on assumptions which could be displaced by the terms of the trust instrument: Bamford at [17]. The general law of trusts operates to give meaning to the term "the income of the trust estate".

4.25 The determination of present entitlement to a share of the income is a process of trust administration. The decision of the Full Court of the Federal Court in *C of T v Totledge Pty Ltd* (1982) 40 ALR 385 at 393 is quoted in support: Bamford at [39]. The High Court distinguished its own decision in *C of T v Australia and New Zealand Savings Bank Ltd* (1998) HCA 53 (Bamford at [39]) as not relevantly addressing the issue. Finally, the Court observed that the Commissioner's lack of consistency in wishing to exclude "statutory income" from "income of the trust estate" did not assist his argument that "income" means "income according to ordinary concepts": Bamford at [41].

4.26 On the meaning of the term "share of the net income" the High Court adopted the proportionate approach advocated by Sunberg J in *Zeta Force* (discussed above).

4.27 What does this translate into for trustees making decisions in respect of trust distributions for the 2010 income year?

4.28 There are a number of relevant observations to be made.

4.29 First, if the Trust Deed provides a formula for determining the income of the trust then that formula will determine the entitlement of the beneficiaries to income. If, for example, the Deed contains words to the following effect:

> *"The net income of the trust is an amount equal to the amount determined in accordance with subsection 95(1) of the* Income Tax Assessment Act 1936 *but reduced by any amount which would otherwise be included by application of Division 207 of the* Income Tax Assessment Act 1997*".*

4.30 Throughout this paper "subsection 95(1) terms" means an amount adjusted for the franking credit gross up. The issue of grossing up is considered below in the context of using the full tax exemption including the franking rebate available to children.

4.31 Leaving aside the elimination of any gross up for franking credits (which itself is affected by the Streaming Amendments as discussed below) the amount of net income for trust law purposes

will equal the tax law income. The two will coincide so that there should, in the ordinary course, be no amount assessable to the trustee under s 99A of the 1936 Act.

4.32 Secondly, if the Trust Deed is silent then "ordinary income" principles apply. Just what they are is difficult to say. The ATO has expressed the view that income of a trust is income according to ordinary principles. This is not the same thing as accounting income determined in accordance with accounting principles. It requires a dissection of receipts into:

4.32.1 income according to ordinary principles;

4.32.2 income which is not ordinary income;

4.32.3 capital receipts.

4.33 Following that dissection, the expenses must be apportioned accordingly.

4.34 This is, of course, all too much. Many trust deeds will have a clause like that in Bamford which allows the trustee to determine whether a receipt is capital or income. Others will have very broad powers allowing the trustee to determine the basis on which income of the trust is to be worked out.

4.35 If these powers exist they should be used to avoid uncertainty brought about by the "ordinary income" approach. If they do not exist then the deed should be to give the trustee such a power. Whether such an amendment will amount to a resettlement, which might have adverse capital gains tax (and stamp duty) consequences, is discussed at **paragraphs xx** below.

4.36 Thirdly, because the proportionate approach has prevailed, a strict application of that rule will mean that great care needs to be taken when seeking to direct a specific amount of tax law net income to a particular beneficiary with absolute certainty e.g. the maximum amount to a child which escapes the punitive rates under Division 6AA of the 1936 Act. This issue is illustrated in the Examples which follow.

4.37 Fourthly, the High Court decision says nothing about streaming of trust income. The matter was not in issue. The uncertainty about streaming of income according to its character remained unabated, until the Streaming Amendments.

4.38 Finally, the ATO has done away with the benevolent "capital beneficiary" approach set out in Practice Statement PSLA 2005/1 (GA) on and from 13 October 2010.

Examples

4.39 The best way to illustrate these points is by way of example. In the examples which follow the following facts apply in relation to the A Family Trust for the income year ended 30 June 2010:

Receipts:

rent	$50,000
net capital gain	$100,000

Expenses:

rental expenses	$10,000
interest	$20,000

4.40 The interest relates to the rental property only. The discountable capital gain was made on the sale of shares in a listed company. The intended beneficiaries are Mr and Mrs A and their two children both under 18.

4.41 Because of the low income rebate the following no-tax thresholds apply to minors:

Income Year end 30 June	**$**
2010	3,000
2011	3,333

4.42 If the income constitutes fully franked dividends the cash payment thresholds and grossed up taxable income amounts are:

Income Year end 30 June	**$ cash**	**$ taxable income**
2010	6,300	9,000
2011	7,000	10,000

4.43 These figures have considerable significance for trustees seeking to hit the no tax "sweet spot" for a distribution to a child.

(a) Subsection 95(1) terms apply – no "balance approach"

4.44 The taxable capital gain is $50,000. Accordingly, the distributable trust income is $70,000.

4.45 For 2010 a minor may be distributed $3,000 with no tax liability if entitled to the low income rebate (see comments above).

4.46 The trust distribution minutes might give effect to the following:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000

70,000

4.47 The tax law results will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.48 The cash in the trust will include the $50,000 covered by the 50% general CGT discount. This is not income and can be dealt with as capital. As this is a discretionary trust it can be distributed without tax consequences.

(b) Ordinary income applies – no "balance approach"

4.49 In this instance the trust distribution minutes will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	7,000
Mr A	7,000
	20,000

4.50 The tax law results will be:

	$
Child 1	$3{,}000 + {}^{3,000}/_{20,000} \times \$50{,}000$
Child 2	$3{,}000 + {}^{3,000}/_{20,000} \times \$50{,}000$
Mrs A	$7{,}000 + {}^{7,000}/_{20,000} \times \$50{,}000$
Mr A	$7{,}000 + {}^{7,000}/_{20,000} \times \$50{,}000$

4.51 The final results:

	$
Child 1	10,500
Child 2	10,500
Mrs A	24,500

Mr A	24,500
	70,000

4.52 This is a strict application of the proportionate approach.

4.53 Each of the children will pay tax on $7,500 at the Division 6AA punitive rates of 45%. This is not a good result.

(c) Subsection 95(1) applies – "balance approach" used

4.54 Trust minutes:

	$
Child 1	3,000
Child 2	3,000
Mrs A	half of the balance
Mr A	half of the balance

4.55 Trust income entitlements:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.56 The tax law result:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.57 This is the same outcome as where no "balance approach" is applied – but see below for the effect of a tax adjustment.

(d) Ordinary income applies – "balance approach" used

4.58 Trust minutes

	$
Child 1	3,000
Child 2	3,000
Mrs A	half of the balance
Mr A	half of the balance

4.59 Trust income created will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	7,000
Mr A	7,000
	20,000

4.60 The tax law results will be:

	$
Child 1	$3{,}000 + {}^{3,000}/_{20,000} \times \$50{,}000$
Child 2	$3{,}000 + {}^{3,000}/_{20,000} \times \$50{,}000$
Mrs A	$7{,}000 + {}^{7,000}/_{20,000} \times \$50{,}000$
Mr A	$7{,}000 + {}^{7,000}/_{20,000} \times \$50{,}000$

4.61 The final results:

	$
Child 1	10,500
Child 2	10,500
Mrs A	24,500
Mr A	24,500
	70,000

4.62 Again there is no difference. However, the "balance approach" is more realistic because it is unlikely that the trust income or tax law income will be known as at any 30 June. In reality these figures are not known until the accounts are drawn later in the calendar year.

(e) Tax Law Adjustments

4.63 It is often important to anticipate an adjustment to the trust's tax law income especially where there is something contentions going on.

4.64 As has been seen the tax law result will follow on a proportionate basis the entitlements to income created under the Deed. To test the outcome it is assumed in the above examples that the trustee failed to recognise $10,000 of rental income (say the trustee at first considered that the income was to be deferred until the 2011 income year) but was in fact wrong about this.

4.65 How do the various approaches deal with such an adjustment?

Example (a) – subsection 95(1) applies (but no "balance approach")

4.66 The trust law entitlements and tax law results were the same:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.67 The tax law adjustment will increase both the trust law entitlement and the tax law income by $10,000. The Trustee has not dealt with this $10,000 and, without an operative default beneficiary clause, it will be assessed to the Trustee under section 99A of the 1936 Act.

4.68 The trust law entitlements and tax law result will be:

	$
Child 1	3000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
Trustee	10,000
	80,000

4.69 However, if there is no streaming of the capital gain (with the effect that all beneficiaries are entitled to a proportionate part of the capital gain) that part of the capital gain reflected in the income to which no beneficiary is presently entitled will be grossed up for the loss of the 50% general CGT discount. Five eighths of the $10,000 adjustment assessed to the Trustee is capital gain. As a result the share of the net income assessable to the Trustee will be increased by $6,250.

4.70 The final result will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
Trustee	16,250
	86,250

4.71 This is a costly outcome.

Example (c) – subsection 95(1) but using a "balance approach".

4.72 The trust law entitlement and tax law result were the same.

	$
Child 1	3,000
Child 2	3,000
Mrs A	half of the balance
Mr A	half of the balance

4.73 The unadjusted result was:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.74 The adjusted trust law entitlement and tax law result will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000 + 5,000
Mr A	32,000 +5,000
	80,000

4.75 The "balance approach" together with adoption of s 95(1) terms directs all of the tax law result from an adjustment made by the ATO to the balance beneficiaries.

4.76 If the balance distribution has been used Mr and Mrs A will "enjoy" a further $5,000 of income entitlement (it now having been correctly determined) and a further $5,000 of tax law net income each. No amount will be assessed to the trustee.

4.77 There is an argument that the beneficiaries have not become presently entitled to the amount of the adjustment to the trust law net income as it was not ascertained at the end of the income year. In the writer's opinion the trust law net income was always the amount as correctly adjusted by the ATO. There was never any uncertainty about it. It is simply the case that the trustee and ATO had not properly determined the correct quantum of income.

4.78 In practical terms how have the Courts looked at the "balance approach"? It has not come up that often.

4.79 The decision of Cooper J in *BRK (Bris) Pty Ltd v C of T* [2001] FCA 164 might at first blush give cause for concern. There the Court considered the operation of the default beneficiary clause in the Trust Deed. The distributions had been:

1993 income year:

"Hendon Unit Trust 100%

and Resolved that should the Commissioner of Taxation disallow any amount as a deduction or include any amount in the assessable income of the Trust, such amount or amounts are to be deemed distributed on 30th June 1993 in the same proportions as listed above to the beneficiaries listed above".

1994 income year:

(a) The sum of $304,021.72 to Westside Commercial Centre Pty Ltd as trustee of the Hendon Unit Trust for its absolute benefit.

(b) The following sums to the following beneficiaries for their absolute respective benefits: NIL

(c) The Balance to Jessica Wagner and Bill Wagner equally between them for their absolute benefit.

1995 income year:

Hendon Unit Trust	*First $220,000*
Northbourne Trust	*Next $100,000*

Wilhelm J Wagner and Jessica O Wagner	*Remainder of balance equally*

4.80 The same "variation of income" clause as in 1993 applied in this year.

4.81 It would appear that the Trust Deed did not adopt subsection 95(1) terms and that income was ordinary income.

4.82 It was found that the Hendon Unit Trust was not an object of the Trust and the distribution of income to it failed. The default beneficiaries clause distributed income in default of appointment to the beneficiaries described in the Schedule to the Deed as tenants in common. This was the usual wide class of family objects.

4.83 The Court concluded that the default beneficiary clause did not operate as at 30 June because the trustee had a reasonable time after the end of the income year in which to decide to distributed or accumulate.

4.84 The question arose as to whether the balance clause in the 1994 and 1995 determinations operated to take the amounts which the Trustee had attempted to distribute to the Hendon Unit Trust to Mr and Mrs Wagner. It was concluded that this was not the effect of the distribution minute and, as a result, the Trustee was assessable under section 99A.

4.85 At [40] Cooper J concluded:

> *"In my judgment the submission is misconceived. In the 1994 income year the clear intention of the applicant was to appoint to Mr and Mrs Wagner only so much of the Trust income, if any, as exceeded $304,021.72 in addition to any income in excess of that amount in the event that the appointment to WCC should fail. The position is no different in respect of the 1995 year. The trustee purported to appoint discrete amounts of income to the Hendon Unit Trust as to the first $220,000 and to the Northbourne Trust as the next $100,000. Finally, as to any remainder after the application of the first $320,000 of income, that remainder was to be appointed to Mr and Mrs Wagner; they did not as a matter of construction or intention on the part of the trustee, take by default all of the income in the event of failure of the other two appointments."*

4.86 Rather than being a cause for concern about the "balance approach" the decision of Cooper J on this point supports its operation. The specific quantum entitlements fix the income (and tax where s 95(1) terms apply) at the amount specified in the Trustee's determination. If the gift fails it does not flow to the balance beneficiary but to the default beneficiary or, in the alternative, there is no such entitlement created, giving rise to a s 99A assessment to the trustee.

4.87 Further comfort can be obtained from observations made in *C of T v Ramsden* [2005] FCAFC 39. In that case the Court was concerned with the issue whether a beneficiary had effectively renounced a distribution of income.

4.88 The distribution minutes for the 1996 income year provided:

"Steve Hart Family Holdings No.2	*$17,295*
Steve Hart Family Holdings No.3	*$6,639*
Unlimited Aerobatic Discretionary Trust	*$34,810*
The Adcock Practice Trust	*$429,000*
Troy B Hart	*$4,750*
Steven I Hart	*The Balance"*

4.89 It was agreed that the Adcock Practice Trust did not qualify as a beneficiary. The default beneficiary clause provided for income which had not been appointed prior to year end to be held for Steven Hart and his three children as tenants in common. The ATO assessed each of the default beneficiaries to one quarter of the amount which had failed to be appointed to the Adcock Practice Trust.

4.90 The argument was pressed before the primary judge that the income should pass by way of the balance distribution to Steven Hart: Ramsden at [38] to [41]. Justice Spender's rejection of this argument was confirmed by the Full Court. It was observed at [2005] FCAFC 39 at [72]:

> *"We agree with this construction. 'The Balance' does not include the amounts which precede "The Balance" in the resolution of 30 June 1996.*
>
> *'The Balance' is the Income of the Trust for the year ended 30 June 1996 other than the amounts which precede it in the resolution in question, whether effectively appointed or not".*[2]

4.91 This observation supports the "balance approach" taken in this paper where there have been effective distributions. Note, however, that it will not work where a distribution is ineffective. In such a case the adjustment will be assessed to the default beneficiary, if there is one, or to the trustee.

Example (d) – Ordinary Income with balance approach applying

4.92 The trust law entitlements were:

	$
Child 1	3,000

[2] [2005] FCAFC 39 at para. 72.

Child 2	3,000
Mrs A	half of the balance
Mr A	half of the balance

4.93 Trust income entitlements:

	$
Child 1	3,000
Child 2	3,000
Mrs A	7,000
Mr A	7,000
	20,000

4.94 The tax law result was:

	$
Child 1	10,500
Child 2	10,500
Mrs A	24,500
Mr A	24,500
	70,000

4.95 When the tax law income is adjusted by $10,000 there is no change to the trust law result. The tax law result will be:

	$
Child 1	$10,500 + {}^{10,500}/_{70,000} \times \$10,000$
Child 2	$10,500 + {}^{10,500}/_{70,000} \times \$10,000$
Mrs A	$24,500 + {}^{24,500}/_{70,000} \times \$10,000$
Mr A	$24,500 + {}^{24,500}/_{70,000} \times \$10,000$

4.96 The final result will be:

	$
Child 1	12,000
Child 2	12,000
Mrs A	28,000
Mr A	28,000

	80,000

4.97 The result has only become worse from a Division 6AA income perspective.

Will a "default beneficiary" clause in the Deed assist?

4.98 An income default beneficiary clause would be expressed something like:

> *"If the Trustee has not determined to distribute all of the net income of the Trust by the end of the Income Year the Income Default Beneficiary will be absolutely entitled to that part of the net income which has not been distributed."*

4.99 The term "Income Default Beneficiary" will be appropriately defined to identify individuals or companies.

4.100 In Example (a) – subsection 95(1) terms but no "balance approach" – a default beneficiary clause would have deflected the tax adjustment from the trustee to the default beneficiary.

4.101 In Example (b) – ordinary income but no "balance approach" – the default beneficiary clause would have no effective operation as all of the trust law/tax law income has been accounted for.

4.102 The trust entitlements were:

	$
Child 1	3,000
Child 2	3,000
Mrs A	7,000
Mr A	7,000
	20,000

4.103 The tax law result was:

	$
Child 1	10,500
Child 2	10,500
Mrs A	24,500
Mr A	24,500
	70,000

4.104 If the tax law income is increased by $10,000 the trust law income does not alter. The tax law adjustment is apportioned according to the trust law income apportionments, as follows:

	$
Child 1	10,500 + $^{3,000}/_{20,000}$ x 10,000
Child 2	10,500 + $^{3,000}/_{20,000}$ x 10,000
Mrs A	24,500 + $^{7,000}/_{20,000}$ x 10,000
Mr A	24,500 + $^{7,000}/_{20,000}$ x 10,000[3]
	70,000

4.105 The final tax results will be:

	$
Child 1	12,000
Child 2	12,000
Mrs A	28,000
Mr A	28,000
	80,000

4.106 In Example (c) – subsection 95(1) terms and a "balance approach" – the default beneficiary clause has no role to play because the adjustment will always be directed to the balance beneficiary.

4.107 In Example (d) – ordinary income and "balance approach" – the default beneficiary clause has no need to operate because the tax adjustment will simply be apportioned in accordance with the trust law entitlements which don't change.

Summary re Tax Adjustments

Trust Accounting Basis	Tax Law Income	Trust Income	Adjustment to (if no default beneficiary)	Adjustment to (if there is a default beneficiary)
subsection 95(1) – no "balance approach"	+ $100	+ $100	Trustee	Default Beneficiary
subsection 95(1) – "balance approach"	+ $100	+ $100	Balance Beneficiaries	Balance Beneficiaries
ordinary income – no "balance approach"	+ $100	no change	All Beneficiaries	All Beneficiaries
ordinary income – "balance approach"	+ $100	no change	All Beneficiaries	All Beneficiaries

[3] The proportions remain the same whether the trust law or tax law results are used.

Guidance from Bamford

4.108 As the High Court observed in Bamford at [17]:

> *"… both sides in argument on the present appeals accepted that whichever of the competing constructions of Div 6 were accepted examples could readily be given of apparent unfairness in the resulting administration of the legislation"*

4.109 In reaching the conclusion that the terms of the Trust Deed determine the trust income to which a beneficiary may be made entitled the High Court has gone very far towards resolving most of the problems and uncertainties which confronted practitioners and the trustees and beneficiaries they advise. With a good understanding of the terms of the Trust Deed as they effect trust distributions most distribution problems can be addressed.

4.110 As has been demonstrated in the above worked examples adopting a s 95(1) terms plus "balance approach" achieves the following:

4.110.1 the quantum of tax distribution to children can be locked in.

4.110.2 any "normal" tax adjustment will flow to the balance beneficiaries.

4.110.3 if used in conjunction with a default beneficiary clause ineffective distributions can also be dealt with.

4.111 The subsection 95(1) but without a "balance approach" can lead to:

4.111.1 an assessment of the tax adjustments to the trustee under section 99A;

4.111.2 clawback of any general CGT discount.

4.112 This can be addressed by using a default beneficiary (of course the default beneficiary should not be a company where the general CGT discount is involved).

4.113 The balance approach together with a considered default beneficiary is to be preferred as the outcome is more predictable.

4.114 The ordinary income approach is problematic because it is:

4.114.1 too difficult to calculate what is net ordinary income;

4.114.2 and tax law adjustments will be spread across all beneficiaries (as there is no adjustment to the net income).

5. Div 7A Amendments

5.1 Division 7A of Part III of the 1936 Act deals with accessing wealth in private companies without accounting for the tax that would otherwise be payable on the value accessed. It focuses on three means of accessing wealth in private companies – payments from a private company, loans from a private company or the forgiveness of a debt by a private company to an associate of that company.

5.2 In 2010 there were two broad changes to the Division 7A interacts with trusts:

5.2.1 The Div 7A Amendments; and

5.2.2 The Commissioner's position in *Taxation Ruling 2010/3* and *Practice Statement Law Administration* 2010/4.

5.3 The changes to Division 7A include the insertion of an introductory note to Division 7A stating:

> An amount may also be included in the assessable income of a shareholder or shareholder's associate if:
>
> (a) a company has an unpaid present entitlement to income of a trust; and
>
> (b) the trustee makes a payment or loan to, or forgives a debt of, the shareholder or associate.
>
> (See Subdivisions EA and EB.)

5.4 This note is of interest as it strongly suggests that Subdivision EA is a 'code' which is intended to capture arrangements where there is an unpaid present entitlement subsisting between a trust and a corporate beneficiary and there is then a loan, payment or forgiveness that occurs between the trustee and a shareholder or an associate of a shareholder in the corporate beneficiary.

5.5 This should be contrasted with the position in the ATO *Taxation Ruling* 2010/3 where the ATO assert that subdivision EA has much more limited effect, where they generally restrict its operation to the situation where there is a sub-trust in existence between a trustee and a corporate beneficiary and there is then loan, payment or forgiveness involving a shareholder or an associate of a shareholder and the trustee of the sub-trust.

5.6 In the 31 March 2010 NTLG meeting the professional bodies questioned the ATO as to whether the introduction of this provision into Division 7A cast doubt on the position in their draft ruling. The meeting agenda includes the following discussion:

> The ATO does not see a conflict between the legislation of provisions dealing with unpaid present entitlements and the position set out in Draft Ruling TR 2009/D8.

This is because, contrary to the premise of the question, under Draft Ruling TR 2009/D8 unpaid present entitlements will retain that status for Division 7A purposes in many situations, including where:

- the amount representing the UPE is physically held on sub-trust for the sole benefit of the private company beneficiary;
- the amount representing the UPE is being used by the trustee but all benefits from this use are held for the sole benefit of the private company; or
- the private company beneficiary is not aware and cannot be taken to be aware that the funds representing its UPE are being used for the potential benefit of any or all discretionary objects of the trust (rather than being physically set aside or used for its sole benefit).

The ATO has appropriately consulted with Treasury prior to and during the drafting of TR 2009/D8.

Provisions within Division 7A dealing with unpaid present entitlements will continue to have their intended application and there is no inconsistency between the Exposure Draft legislation and the draft Ruling.

Use of assets

5.7 As was announced in the 2009/10 Federal Budget the use of assets owned by private companies, or owned by trusts where there is a present entitlement owing to a private company may be subject to tax after 1 July 2009.

5.8 The way in which the use of assets will become subject to tax is through the amendment of the definition of the term 'payment' in Division 7A so that it extends to the provision of an asset (other than a transfer of property) for use by an entity. Consistent with the present operation of Division 7A the provision of the asset will only result in Division 7A consequences where the asset is provided to a shareholder or associate of a shareholder.

5.9 For the purposes of Division 7A the payment will occur when the use of the asset occurs.

5.10 A payment will also arise however where the asset is not used, but is available for use. The examples in the EM are illustrative of when it will be the right to use the asset, and not its use, that is subject to the Division 7A rules.

> ***Example (right to use from EM)***
> ***Brian is a shareholder of a private company that owns a luxury yacht. He does not have a formal agreement with the company in relation to the yacht, however, he takes the yacht out every second weekend.***
>
> ***Brian keeps the yacht at the company's business premises, but takes the key home. Brian stores several personal items on the yacht.***
>
> ***Brian's fortnightly use of the yacht is a payment under Division 7A. The availability of the yacht for Brian's use is also subject to Division 7A because the yacht is not readily available for use by the company. The company would need to arrange with Brian to***

get the key and for the removal of Brian's personal items before using the yacht. That is, the asset is available for Brian's use to the exclusion of the company.

Example (use from EM)
Marina is a shareholder of a private company that owns a city apartment. The apartment is generally available for rent. However, Marina asks the company not to rent the apartment out for a week so that she and her family can use the apartment over a long weekend. Marina's use of the apartment is a payment for the purposes of section 109CA.

5.11 An issue that arose on consultation over the draft legislation giving effect to these changes was whether the mere availability of assets to a shareholder or associate would result in the shareholder or associate being treated as having the asset available for their use. The EM again includes an example where there a payment is not taken to arise where an asset is available as a result of a general entitlement to use an asset without actual use of the asset.

Example (mere entitlement from EM)
Peter is a shareholder of a private company that owns five cars for company use. Shareholders and their associates have general permission to use the cars on weekends if they are not being used for company business. Peter regularly takes one of the cars home.

Peter's use of the car that he takes home will be subject to Division 7A. This will include driving the car (actual use) and the availability of the car for his use to the exclusion of the company, such as when it is parked at home, or at a restaurant that Peter is visiting.

Although Peter may have general permission to use all five of the cars, he does not use all of them for the purposes of Division 7A. The four cars that Peter leaves at the company premises are available for the company to loan to another shareholder, employee, customer, or other party. That is, these cars are not available to Peter to the exclusion of the company.

5.12 The EM also includes examples of where an asset is available to more than one shareholder or associate and it is necessary to determine who is taxed. The EM suggests and apportionment of the taxable value to the person who is the real recipient of the benefit. One example sets out that a minor that benefits should not be taken to receive a Division 7A payment, where another sets out that incidental use by a spouse of a vehicle provided to a shareholder would not result in the spouse being taxed on the benefit provided.

5.13 In valuing the payment taken to be made it will be the amount that would have been paid for the use of the asset in an arm's length dealing less any consideration paid that will be determined to be the payment for Division 7A purposes.

5.14 There are a number of exceptions from the payment provisions applying, including one not previously announced dealing with residential property:

5.14.1 Minor benefits – if the provision of the asset would have been a minor benefit under section 58P of the FBTAA had it been provided to an employee then the benefit will be disregarded for Division 7A purposes

5.14.2 Otherwise deductible payments – if a once off deduction would have been available to the shareholder or their associate in connection with the use of the asset then there will be no benefit to be taken into account for Division 7A purposes.

5.14.3 Dwellings – the use of a dwelling can be exempt where the following conditions are satisfied:

5.14.3.1 the entity or their associate is carrying on a business;

5.14.3.2 the entity or their associate uses or is granted or has a lease, licence or other right to use land, water or a building for the purpose of carrying on the business; and

5.14.3.3 the provision of the dwelling to the entity is connected with that use or with that lease, licence or other right to use the land, water or building to carry on the business.

5.14.4 Main residences – the provision of a dwelling that is a person's main residence does not result in a Division 7A payment where:

5.14.4.1 The provider of the dwelling is a private company;

5.14.4.2 The private company acquired the dwelling before 1 July 2009; and

5.14.4.3 The private company would pass COT from the time that the dwelling was acquired until the end of the time that a payment could be taken to be made under Division 7A.

5.14.5 Vacant land – if the exception for a dwelling or a main residence applies, it will extend to adjacent land in the same way as occurs in the main residence exemption.

Corporate limited partnerships

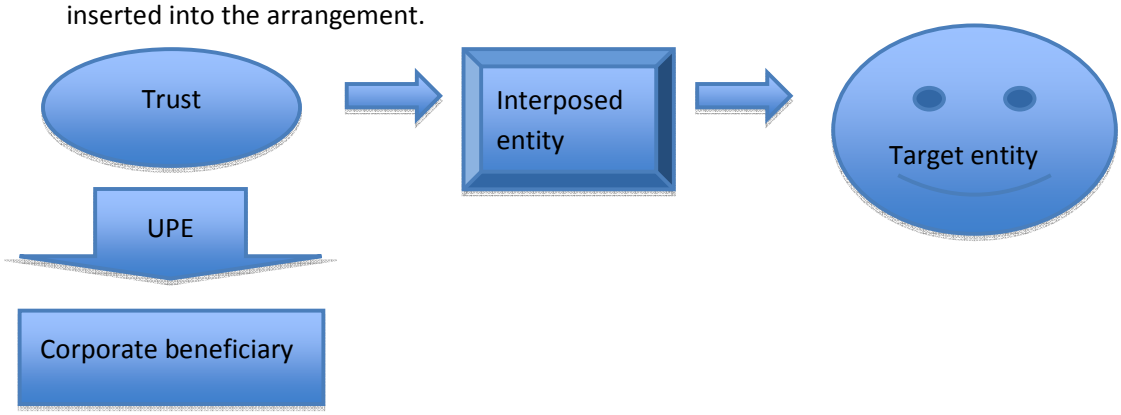
5.15 Closely held corporate limited partnerships (limited liability partnerships) will also now be subject to Division 7A. A corporate limited partnership will be closely held where it has fewer than 50 members or where an entity has, directly or indirectly, for the entity's own benefit, an entitlement to 75% or more of the income and capital of the partnership.

Interposed entities

5.16 The Div 7A Amendments fix two drafting issues in relation to the use of interposed entities.

5.17 The Division 7A legislation as originally drafted allowed for a payment by a private company through an interposed entity to be treated as a payment for Division 7A purposes.

5.18 The legislation did not however on a plain reading, allow for a trust where there was an unpaid present entitlement, to be deemed to have made a payment where an interposed entity was inserted into the arrangement.



5.19 A payment from the trust through an interposed entity to a target entity will now be caught by Division 7A if a reasonable person would consider that a loan or payment made to the interposed entity was made to enable a loan or payment to be made by the interposed entity to the target entity.

5.20 Consistent with the current operation of Subdivision EA however, a payment through to the target entity will only result in a Division 7A deemed dividend if it is referable to a reduction in a present entitlement that is in itself attributable to an unrealised gain in the trust.

5.21 The Div 7A Amendments also ensures that where an unpaid present entitlement is owed to a company by a trust, but the loan, payment or forgiveness that occurs does not involve the trust that owes the unpaid present entitlement, that Subdivision EA still has effect.

5.22 Subdivision EA will apply to treat a loan or payment from a trust as being a Division 7A loan or payment to the extent that the loan or payment is referable to an unpaid present entitlement owed to a private company where that amount has not already resulted in a Division 7A loan or payment.

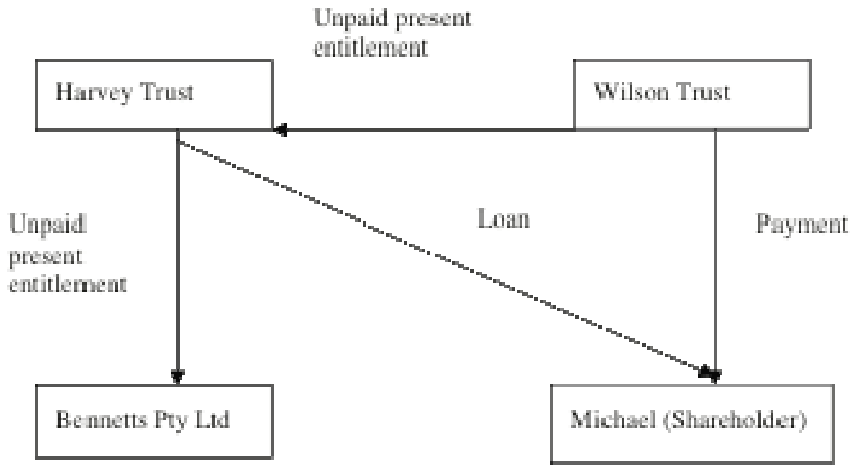
Example (interposed trust from EM)
Michael is a shareholder of Bennetts Pty Ltd and Bennetts Pty Ltd is a beneficiary of Harvey Trust. In the 2009-10 income year, Michael receives a payment from the trustee of the Wilson Trust, which is attributable to an unrealised gain. He receives this payment

because of his shareholding in Bennetts Pty Ltd. Michael also receives a $2,000 non-compliant Division 7A loan from the Harvey Trust.

Bennetts Pty Ltd is not presently entitled to an amount from the net income of the Wilson Trust. However, Bennetts Pty Ltd is entitled to $10,000 from the net income of the Harvey Trust (the first interposed trust) and Harvey Trust is presently entitled to $10,000 from the net income of the Wilson Trust. These amounts remain unpaid.

The loan made by the Harvey Trust to Michael will be included in Michael's assessable income under ordinary operation of subsection 109XA(2).

Bennetts Pty Ltd is taken to be presently entitled to $8,000 from the Wilson Trust, which is the unpaid present entitlement of $10,000 from the Harvey Trust, reduced by the $2,000 loan amount that is included in Michael's assessable income under another provision of Subdivision EA.



Loan back arrangements

5.23 Subdivision EA as currently drafted only captures payment arrangements where the payment is a reduction of a present entitlement that is referrable to an unrealised gain.

5.24 To circumvent these rules, apparently it had been suggested that the following arrangement could be entered into:

5.24.1 An unpaid present entitlement exists to a private company, say of $100,000.

5.24.2 A payment is made by the trustee of the trust to a beneficiary of an amount far in excess of the UPE, for example $1 million.

5.24.3 The amount in excess of the UPE is then loaned back to the trustee, being $900,000.

5.24.4 Thus, the beneficiary now has a credit loan of $900,000.

5.24.5 In future years the trustee appoints income to the company and uses the funds to repay the credit loan.

5.25 The need for there to be a payment referrable to a reduction of an unrealised gain will be removed where the payment made to a beneficiary is in reduction of a loan made on or after 1 July 2009 where a reasonable person would conclude that the trustee obtained the loan in order to make the payment.

Amendment to distributable surplus definition

5.26 The definition of distributable surplus will be amended so that amounts that have been deemed to be dividends as a result of the operation of Subdivision EA will be removed from the distributable surplus (by being correctly included as non-commercial loans).

Forgiveness of 109XB loans

5.27 There is a drafting problem that will be rectified so that the forgiveness of a loan by a trustee that has already been deemed to be a dividend will not result in a subsequent dividend. The law already applies in this way to the forgiveness of a debt owed to a private company by a shareholder that has already been deemed to receive a dividend under Division 7A.

Dividend set-off

5.28 Another drafting problem dealing with dividend set-offs will also be rectified.

5.29 At present, where a private company makes a loan that is deemed to be a dividend and later pays an unfranked dividend that is set off against that loan the later dividend is not included in assessable income.

5.30 The ability to disregard the later dividend does not apply where the loan was made by the trustee of a trust and where the deemed dividend arose under section 109XB.

5.31 The ability to disregard a later unfranked dividend offset against a loan from a trustee is being introduced.

Setting off employment entitlements

5.32 Another unusual aspect of the interaction of Division 7A generally and Subdivision EA has been that employment related payments that are offset against loans by trustees do not count as repayments if there is a borrowing of a similar or greater amount to the amount repaid. This is in contrast to setting off such a payment against a loan by a company where the repayment is taken into account even if there is a further borrowing.

5.33 This anomaly is to be rectified.

Borrowing to repay

5.34 Under the previous law a repayment is disregarded where the repayment is made where a reasonable person would conclude the repayment was made in order to borrow a similar or greater amount. This prevents a person from borrowing funds during a financial year, repaying on 30 June, and then reborrowing the amount on 1 July.

5.35 While the law has operated in this way (with some exceptions for repayments that occur by way of offsetting assessable amounts such as the wages noted above) it arguably has not operated where, instead of repaying to borrow, a person borrows to repay. This was be remedied so that a borrowing to repay will also activate section 109R.

> ***Example (from EM)***
> ***Alicia obtains a loan of $10,000 from Cleary Pty Ltd. Alicia has until the lodgment day to repay the loan. Two weeks before the lodgment day Alicia obtains a further $10,000 from Cleary Pty Ltd. She then repays the original $10,000 loan a week before the lodgment day.***
>
> ***The repayment of the original $10,000 loan is not a repayment for the purposes of section 109D, because Alicia has borrowed a similar amount from Cleary Pty Ltd and in this case a reasonable person would conclude that the loan was obtained in order to make the repayment of the original $10,000.***
>
> ***The original $10,000 loan is treated as a deemed dividend subject to the distributable surplus of the private company.***

Adding back payments for Division 7A purposes

6. Streaming

6.1 The paper will no consider the importance of, and ability to, stream as it stood before the Streaming Amendments. Then it will consider the Streaming Amendments.

Pre-Streaming Amendments

6.2 As can be seen from the illustrations above the ability to stream income according to its character is very important. This is particularly the case for franked dividends and capital gains but there are other forms of income with tax characteristics that may also be important e.g. income from a foreign source, income which has been subject to TFN withholding tax.

6.3 The decisions in Bamford tell us nothing about streaming income for tax purposes.

6.4 Most modern trust deeds will give the trustee power to distinguish between classes of income and to characterise a particular amount of income as having been derived from a particular source. The Deed should also allow the trustee to allocate expenses to the different classes of income.

6.5 The law regarding streaming after the decision in *CPT Custodian Pty Ltd v Commissioner of State Revenue [2005] HCA 53* ("**CPT Custodian**") was quite uncertain. The decision of the High Court in *Charles v C of T [1954] HCA 16* ("**Charles**") has always been the centre of gravity of the character flow through approach. The decision in Charles was heavily criticised by the Court in CPT Custodian. The question is whether that criticism went to the maintenance of character or is restricted to the characterisation of the interest in the trust fund by looking through to the underlying assets.

6.6 The decision of the High Court in CPT Custodian, in the writers' views, stands for the proposition that a beneficiary has an equitable interest in the residue of the trust fund after the Trustee's indemnity has been satisfied. This residue is characterless, whether it be income or capital, as the trustee may at any time satisfy its right to be indemnified from the receipts (which themselves have character).

6.7 Notwithstanding these problems the ATO has consistently taken the view that the character of the income in the hands of the beneficiary is taken from the character of the receipts of the Trustee[4] even after taking into account the decision in *CPT Custodian*[5].

6.8 In the non-binding ruling IT2328 (now withdrawn) it was observed:

> *"For income tax purposes where a beneficiary in a trust estate is presently entitled to the net income or a share of the net income of the trust estate, that income as a general principle has the same character in the hands of the beneficiary as it had in the hands of the trustee."*

6.9 The most significant streaming issues concern capital gains and dividends. In the case of capital gains Division 115 of Part 3-1 of the 1997 Act proceeds on an implication that income entitlements will take on at least some part of the character of the capital gains derived by the trustee. There is no clear legislative follow through. The guidance found in Sesction 115-200 of the 1997 Act establishes the implied maintenance of character:

> *"This Subdivision sets out rules for dealing with the net income of a trust that has a net capital gain. The rules treat parts of the net income attributable to the trust's net capital gain as capital gains made by the beneficiary entitled to those parts."*

[4] see in particular ATO ID 2008/51 dealing with Division 13.3A of the SIS Regulations.

[5] see Taxation Ruling STR 92/13, IT2328, IT2512, IT2004 (withdrawn) and ATO ID 2007/108 (which is concerned with foreign sourced income and in respect of which subsection 6B(2A) of the 1936 Act also comes into consideration).

6.10 Subsection 115-215(1) is the nub of the provisions:

> *"The purpose of this section is to ensure that appropriate amounts of the trust estate's net income attributable to the trust estate's capital gains are treated as a beneficiary's capital gains when assessing the beneficiary, so:*
>
> *(a) the beneficiary can apply capital losses against gains; and*
>
> *(b) the beneficiary can apply the appropriate discount percentage (if any) to gains."*

6.11 The process is described as attribution rather than maintenance of source character. This may be the necessary distinction to make the rules work. There is, however, no guidance about how the attribution is to be carried out.

6.12 What is clear is that if there is no trust income to which the beneficiary is presently entitled there can be no attribution. This is a major issue where there is no trading income but there are capital gains in the Trust. Use of s 95(1) terms to describe income overcomes this problem and makes the case for attribution much clearer. The capital gain (or at least 50% of it) will be included in the income. The connection for Subdivision 115-C purposes is very clear.

6.13 The ATO has had to resort to the artificiality of the "capital beneficiary approach" in PS LA 2005/1 (GA) to achieve this sensible outcome – but this practice statement was withdrawn following Bamford.

6.14 The issues with streaming can be readily appreciated in the context of capital gains and the 50% general CGT discount. The streaming issue is, of course, the denial of the 50% CGT general discount when a trust to company distribution is in play.

6.15 Maintaining the example used above in which there is a net capital gain of $100,000, and gross rental income of $50,0000 and net rental income of $20,000.

6.16 In this instance the trustee wishes to cause the capital gain to be assessed in the hands of an individual (say Mrs A) and the net rental income in the hands of a company, A Co. If it is assumed that the Trust Deed has all of the usual income characterisation and streaming provisions and the Deed adopts subsection 95(1) terms, the outcome readily appears.

6.17 The income entitlements are:

	$	
A Co	20,000	comprising net rental income
Mrs A	50,000	comprising the capital gain
	70,000	

6.18 If the ATO took the view that streaming was unobtainable the outcome would be:

	$	$ Total
A Co	5,714 + taxable capital gain $28,572	34,286
Mrs A	50,000	50,000
		84,286

6.19 The other area of concern is franking credits. At least there is a ruling on this aspect of streaming, *Taxation Ruling* 92/13 (repealed as of 22 June 2011 because of the Streaming Amendments). The provisions of Subdivision 207-B and in particular ss 207-45 to 207-57 are consistent with flow through of the franked character of a dividend.

6.20 The fact the Example set out immediately below s 207-35(3) of the 1997 Act depends on character maintenance. It is worthwhile setting this Example out in full:

> *"A franked distribution of $70 is made to the trustee of a trust in an income year. The trust also has $100 of assessable income from other sources. Under subsection (1) the trust's assessable income includes an additional amount of $30 (which is the franking credit on the distribution). The trust has a net income of $200 for that income year.*
>
> *There are 2 beneficiaries of the trust, P and Q, who are presently entitled to the trust's income. Under the trust deed, P is entitled to all of the franked distribution and Q is entitled to all other income.*
>
> *The distribution flows indirectly to P (as P is entitled to a share of that net income and has a 100% share of the distribution under section 207-55). P therefore has an amount of assessable income that is equal to its share of the distribution. Under this subsection, P's assessable income also includes the full amount of the franking credit (as P's share of the franking credit on the distribution is $30 under section 207-57). Q's share of the net income therefore does not include any of the franking credit."*

6.21 Clearly the legislation contemplates maintenance of character for the purposes of dividend imputation.

Commissioner's Concern of Division 6 Abuses

6.22 As usual the ATO is driven by the possibility that the decision in Bamford might support some abuse and revenue loss. No matter that their interpretations lead to massive headaches for practitioners.

6.23 This much is exampled by several examples set out *in Practice Statement PS LA 2009/7* which was released prior to the decision in Bamford.

6.24 Examples 1 and 5 in particular show what the ATO is on about.

6.25 Example 1 concerns the trustee of a family trust deriving $250,000 in income during the income year and applying that income to the purchase of a holiday home. The trustee, acting in accordance with a power expressed in the terms of the Trust Deed to do so, determines that the expenditure on the purchase of the house is an outgoing on income account with the effect that the trust law income available for distribution is $5,000. One of the beneficiaries has tax losses.

6.26 The trustee distributes the $5,000 trust law income to the loss beneficiary. The losses cover the tax law income which follows the trust law income to the loss beneficiary.

6.27 The ATO expresses concern about the mismatch of the actual amount to which the beneficiary becomes entitled ($5,000) and the amount of the tax law income flowing to the beneficiary ($250,000) and the tax not paid because of the losses.

6.28 It is difficult to say why this is of concern to them. The true effect of the transaction is to maintain $245,000 in the capital of the trust. The same tax effect would be obtained by distributing all of the $250,000 to the loss beneficiary. There is no tax difference in this illustration. It is unlikely there would be a tax benefit for the purposes of Part IVA. The most likely explanation for the transaction is the financial risk the loss beneficiary has been exposed to. If the beneficiary became entitled to call on the trustee to pay him or her $250,000 the creditors may be able to stake a claim to that amount. It is a neat and sensible piece of asset protection planning.

6.29 Example 5 is about a trust which has distinct income and capital beneficiaries. The trustee has a power to determine whether receipts and outgoings are on income or capital account. The Trust Deed is amended to admit a tax exempt entity as a beneficiary.

6.30 The trust derives $100,000 of income (meaning income according to ordinary concepts) during the income year. The trustee determines that $95,000 of that amount is a capital receipt. The remaining $5,000 is the trust law income according to the Trust Deed. This amount is appointed to the tax exempt beneficiary. All of the tax law income will be assessed to the charity. It would follow that the trustee makes a capital distribution of the $95,000 to a family beneficiary.

6.31 The ATO observe in the Practice Statement that Part IVA might apply in the circumstances. In the writer's view it almost certainly would do so in particular because of the amendment to introduce the tax exempt charity as a beneficiary and the fact that prior year distributions had been made only to family members. A much more challenging (and perhaps more realistic) illustration would arise if the tax exempt charity was already an object and the trustee had made distributions to charities in the past. The Part IVA case in such circumstances would be difficult to make out. This is an example of the acknowledged "apparent unfairness in the resulting administration of the legislation" as noted by the High Court in Bamford at [17].

6.32 The ATO apparently accept that Bamford authorizes characterization of capital receipts as income for the purposes of the Deed but are not so ready to accept that ordinary income may be recharacterised as capital (as in Example 5). They appear to be fortified in this by observations made by the Full Court of the Federal Court in *Forrest v C of T* [2010] FCAFC 6 ("**Forrest**").

6.33 The relevant question before the Court there was whether Mr Forrest was entitled to a deduction for interest he had incurred in relation to funds he had borrowed to acquire units in a unit trust. The outcome turned on whether there was a fixed income component to which the funds related. The Full Court concluded that a power to determine whether any amount received by the trustee was on revenue account or capital account (clause 12 of the Deed) was not a power to change the beneficiaries' rights. In so doing they observed at [11]-[12]:

> *'In our opinion, the power conferred by cl. 12 cannot be exercised by the trustee wrongly to classify a receipt as a capital gain, when the receipt is, in truth, income, and thus deprive the appellant of his interest in the unit component of the trust. Clause 12 is not an unlimited power to be exercised in the trustee's unconfined discretion….*
>
> *Clause 12.2(a) is a power to determine how a distribution to beneficiaries is classified. That limited power is not a power which is capable of altering the beneficiaries' rights. Clause 12 is to be read consistently with the balance of the Trust Deed and an appreciation that it contains various powers of an administrative character. The words used can be given full force honestly to classify income or distributions according to law, as the appellant contended to this Court".*

6.34 It is very difficult to know how far this goes. The issue in Forrest was about whether or not the exercise of the power changed the rights as between classes of beneficiaries. Presumably the ATO would say that the exercise of the power in a case like that in Example 5 was not an "honest" classification of the receipt as capital. Hopefully the issue will not arise very often.

Point of Interest

6.35 A case of interest is *Greenhatch v FCT* [2011] AATA 479 that ostensibly concerned superannuation contributions where the answer to the superannuation question was determined by construing streaming through a trust. The case of is interest for two reasons.

6.36 First, the AAT went out of their way to note the Commissioner's interpretation of Bamford was wrong. At [49] and [50] they said:

> *Much, if not all, of the Commissioner's case turns on his rejection of any underlying conduit theory and his interpretation of the implications of the decision in Bamford.*

The Commissioner's contention that the conduit theory has no role to play is based on foundations with which we do not agree. Accordingly, those foundations do not support the conclusion he seeks to draw.

6.37 Secondly, in relation to Subdivision 207-B of the 1997 Act, being the franking credits provisions, the AAT observed at [63]:

> *Section 207-35 of the 1997 Act has an aspect that makes the conclusion [that] amounts passing through trusts to beneficiaries thereof carry the character and identity that they had in the hands of the trustee more compelling. That section includes an example that contemplates differential distributions in determining the taxation burdens that are imposed on the beneficiaries of the trust.*

6.38 Question: was it necessary to introduce the Streaming Amendments in light of the above comments? Given we have the Streaming Amendments it is of academic interest only.

Streaming Amendments

6.39 The *Tax Laws Amendment (2011 Measures No. 5) Act* 2011 (Cth) was introduced into parliament (as a Bill) on 2 June 2011, was passed unamended and assented to on 29 June 2011. They take effect from 1 July 2010. These dates show how close a call it was as the Streaming Amendments are critical for trustee decisions that were needed to be made on 30 June 2011 – one day after their royal assent.

6.40 Subject to a statement by the Commissioner – extending the time a trustee could make decisions to 31 August 2011, which has anyway passed, but the writers question the Commissioner's ability to alter what trust law[6] requires to be done on 30 June of any year – the Streaming Amendments apply to trustees resolving to deal with trust income and capital gains.

6.41 From the 2011 income year and thereafter taxable capital gains and franked distributions are dealt with under these rules.

6.42 The Streaming Amendments operate by diverting from Division 6 of the 1936 Act the franked distributions and taxable capital gains. They are assessed directly in the hands of the beneficiaries who are presently entitled to them. They do this via Subdivision 207-B of the 1997 Act for franked distributions and via Subdivision 115-C of the 1997 Act for taxable capital gains. However, for the taxable capital gains they must still pass through the method statement in s 102-5(1) of the 1997 Act.

[6] *Trustees of the Estate Mortgage Fighting Fund Trust v FCT* [2000] FCA 981 per Hill J; *Case R105,* 84 ATC 692; *Antonopoulos v FCT* [2011] AATA 431.

6.43 The Streaming Amendments have introduced a new Division 6E into Part III of the 1936 Act to prevent double taxation. It adjusts the Division 6 income and net income of the trust to take out the amounts to which the beneficiary has been made specifically entitled.

6.44 It can be seen that the specific entitlement of the beneficiary or beneficiaries is the critical aspect of the Streaming Amendments. This is required to determine tax liability.

Specific Entitlement

6.45 The notion of a specific entitlement conceals the difficulties of applying the Streaming Amendments to all trusts, be they discretionary, fixed, unit, et cetera. The mechanism by which you become specifically entitled are set out in the relevant Subdivisions: s 115-228 for capital gains and s 207-58 for franked distributions. The provisions seem substantially similar at first look but there are some significant differences.

6.46 A beneficiary is specifically entitled under s 207-58 of the 1997 Act to an amount of a franked distribution made by the trust equal to the amount calculated under the following formula

$$\text{Franked Distribution} \times \frac{\text{Share of net financial benefit}}{\text{Net financial benefit}}$$

6.47 The "net financial benefit" is an amount equal to the financial benefit referable to the franked distribution (after an application by the trustee of expenses that are directly relevant to the franked distribution).

6.48 The term "financial benefit" is already in s 995-1 f the 1997 Act. It means anything of economic value, even if the transaction also imposes an obligation on the entity. Benefits and obligations are to be looked at separately and not set off against each other, but it is the net financial benefit to which the formula looks.

6.49 The "share of the financial benefit" is the amount of the financial benefit referable to the franked distribution specifically linked to the particular beneficiary. The share of the net financial benefit is:

> *… an amount equal to the *financial benefit that, in accordance with the terms of the trust:*
>
> *a. the beneficiary has received, or can be reasonably expected to receive, and*
>
> *b. is referable to the *franked distribution (after application by the trustee of any expenses that are directly relevant to the franked distribution) and*
>
> *c. is recorded, in its character as referable to the franked distribution, in the accounts or records of the trust no later than the end of the income year.*

6.50 Section 115-228 is identical to the discussion above of franked distributions, subject to:

6.50.1 the financial benefit must be referable to the capital gain "after application by the trustee of any losses, to the extent that the application is consistent with the application of capital losses against the capital gain in accordance with the method statement in subsection 102-5(1)"; and

6.50.2 the recording of the financial benefit must be "no later than 2 months after the end of the income year."

Complexities and Going Forward

6.51 An issue to be mindful of is – in fact an issue of significant importance – is that a trust with no "income", which was one of the problems in the Bamford appeals, will not be able to stream franking credits. This will mean that where the franked distributions, together with other ordinary income, is insufficient to more than offset expenses of the trust the franking credits cannot go through to the beneficiaries. The same restriction does not apply in relation to capital gains streamed through the trust.

6.52 Ken Schurgott FTIA, in his paper in the August 2011 *Taxation in Australia* titled "Trust streaming 2011" notes a number of complications that arise from the Streaming Amendments:

> *As will be seen, there are a number of issues which emerge that complicate the legislation over and beyond the rather simple approach adopted prior to the Commissioner's stance on streaming. The things which complicate matters are:*
>
> *a. There can be different outcomes according to the definition of income adopted by the trust deed;*
>
> *b. Significantly different outcomes can result where a beneficiary has not been made specifically entitled to the franked distribution or capital gain. This is most pronounced in relation to capital gains;*
>
> *c. The concept of making a beneficiary entitled to the entire financial benefit from a capital gain or franked distribution is fraught with difficulty, particularly where there are capital losses or directly related expenses; and*
>
> *d. The way in which capital losses and directly related expenses are to be dealt with is confusing.*

6.53 It can be seen from these further issues, and the problem of actually apply what is a simple concept of diverting the amounts to Subdivisions 115-C and 207-B respectively, are anything but straightforward or settled. Indeed, a senior council on the writer's floor, after having advised on

the Streaming Amendments is of the view that this is where future archeologists will find the bones of 21st Century tax lawyers and accountants.

7. Changes to the taxation of trusts – terms to be provided for in a trust document

7.1 Given the changes in the taxation of trusts, it is recommended that trust deed (or any other constituent documents) be reviewed so as to determine:

7.1.1 How income, capital gains and outgoings are accounted for and determined; and

7.1.2 How income, capital gains and outgoings are to be distributed.

7.2 Some of the powers which may be advantageous to have within a trust instrument include:

7.2.1 an accounting policy which is sufficiently broad and allows the trustee to exercise maximum discretion;

7.2.2 the discretion to reclassify and allocate income and capital gains;

7.2.3 the discretion to reclassify and allocate outgoings;

7.2.4 the discretion not to recoup losses (whether income or capital in nature);

7.2.5 the ability to allocate and stream classes of income and capital and their related tax attributes;

7.2.6 and ensure that any unpaid present entitlement / loan provisions are removed, and an ability to hold amounts subject to a sub-trust.

7.3 Some additional powers to be considered include:

7.3.1 whether the trustee has the power to distribute income and / or capital at any time within a tax year;

7.3.2 whether any determination of income (or capital) can be made within the income tax year; and

7.3.3 whether the trustee has a power to determine entitlements with respect to an income tax year after the relevant year.

Accounting policy

7.4 Essential is ensuring that the trust deed provides guidance with respect to an accounting policy that should be used by the trustee. Such an accounting policy should provide sufficient flexibility for the trustee, so that it may depart from generally accepted accounting standards in the event that the trustee considers that it is appropriate to do so.

Reclassifying and allocating income and capital

7.5 As the High Court in *Bamford* accepted that the tax law income of a trust is dependent upon (amongst other things) the definition of that term in the trust deed, regard should be given to the definition of the 'income' as contained in the trusts constituent documents.

7.6 An issue to consider is whether attributed amounts (e.g. franking credits) should be included within the definition of trust income. An issue that arises is that if attributions are included in trust income (and which are not physically 'paid' by a trustee – but which follow certain amounts of income), whether by being included in trust income, and thereby providing that a trustee creates a 'present entitlement' in a beneficiary to an amount that is never received by a trustee, the trustee will be exposed to a claim in relation to amounts that are not actually received by the trustee.

7.7 It is submitted that amounts such as franking credits should be prima facie carved-out of the definition of income. However, the definition should contain discretionary elements to allow a trustee to cause such 'attributed' amounts to fall within the definition of income.

7.8 An approach which may be considered is, in defining trust income:

7.8.1 Provide that it prima facie equals the amount provided for in s 95(1) of the 1936 Act (less any franking credits);

7.8.2 If the tax law approach is not warranted for a particular tax period, then:

7.8.2.1 According to an accounting policy adopted by the trustee; or

7.8.2.2 Any other basis as determined by the trustee; or

7.8.3 In the trustee's absolute discretion, the gross income of the trust.

Reclassifying and allocating outgoings

7.9 In *Cajkusic v FC of T (No 2)* (2006) ATC 4752 ("**Cajkusic**") deductions allowable to a family discretionary trust for payments that were made under an employee benefits trust arrangement in the income tax years ending 30 June 1997 and 30 June 2008 caused there to be a loss within the trust estate.

7.10 As a result of the losses, there was no distributable income of the trust. As a result, the Full Court of the Federal Court held that the lack of distributable income meant that there could be no beneficiary of the trust (for the relevant income tax years) to be "*… presently entitled …*'"pursuant to s 97 of the 1936 Act to any amount.

7.11 It should be noted that the Commissioner's subsequent application for special leave to appeal to the High Court was rejected.

7.12 Cajkusic stands for the proposition that the 'distributable income' of a trust is determined by reference to proper accounting principles, as well as the terms of a trust deed. In this context distributable income is income determined according to accounting principles, and which is distributable amongst the beneficiaries. It does not alter either the income as calculated under accounting principles, of the 'net income' as determined under s 95(1) of the 1936 Act – rather, only gives a trustee the power to determine the distributable amounts.

7.13 As a result of the decision in Cajkusic, it is submitted that a trust deed should give a trustee the power to reclassify, and allocate outgoings, so that there can be 'distributable income' to which beneficiaries are presently entitled.

Discretion not to recoup losses (whether income or capital in nature)

7.14 It is recommended that a trustee have a discretion not to recoup losses (whether of an income or capital nature). That is, a power not to recoup losses which have arisen in the past.

8. Resettlement considerations

8.1 Whenever the terms of a trust are varied, an issue to consider is whether the variation amounts to a 'resettlement'.

8.2 Resettlements relate to changes to a trust relationship which have the effect that a new trust estate comes into existence. According to the High Court in *FC of T v Commercial Nominees of Australia Ltd* [2001] HCA 33 (***"*Commercial Nominees"**), the issue to determine is whether '*… what occurred* … [i.e. the variation] … *was a fundamental alteration in the trust relationship*

established by the original deed, such that it destroyed the necessary continuity of the 'taxpayer'…'.

8.3 A resettlement can have significant income tax, capital gains tax (**'CGT'**) and stamp duty consequences, including that:

8.3.1 the trust property may be disposed of, potentially triggering both stamp duty and CGT liabilities;

8.3.2 carried forward tax benefits may be lost; and

8.3.3 beneficiaries may dispose of their interests in the original trust and acquire interest in a new trust.

8.4 Specifically in the context of CGT, a resettlement may cause either CGT event E1 (s 104-60 of the 1997 Act) or CGT event E2 (s 104-65 of the 1997 Act) to happen.

8.5 In August 2001 the issued a Statement of Principles entitled *Creation of a new trust* (the **"Statement**"). The Statement clarifies when, in the Commissioner's view, changes to a trust gives rise to a new trust. The Commissioner considers that a new trust estate arises where there is a 'fundamental change to a trust relationship' – ie, a change in the essential nature and character of the original trust relationship. Further, the Commissioner considers that a new trust (i.e. a resettlement) may arise in the following circumstances:

- a change in beneficial interest in trust property;
- a new class of beneficial interest (whether introduced or altered);
- a redefinition of the beneficiary class;
- changes in the terms of the trust or the rights or obligations of the trustee;
- changes in the nature of the trust property;
- additions of property which could amount to a new and separate settlement;
- depletion of trust property;
- a change in the termination date of the trust;
- a change in the trust that is not contemplated by the terms of the original trust;

- a change in the essential nature and purpose of the trust; and / or
- a merger of two or more trusts or a splitting of the trust.

8.6 The Commissioner considers that depending on their nature and extent, the above changes may either amount to:

8.6.1 a variation of a continuing trust; or

8.6.2 a fundamental change in the essential nature and character of the trust relationship. In such a case, the original trust may be brought to an end and a new trust created. Whether a new trust is created depends on the terms of the original trust and on the powers of the trustee.

8.7 The High Court in Commercial Nominees held that significant changes to a superannuation fund trust deed did not create a new trust, even though the amending deed had:

8.7.1 changed the name of, and appointed a new trustee to the fund;

8.7.2 introduced a new category of beneficiaries;

8.7.3 changed the fund from a defined benefit fund to an accumulation fund;

8.7.4 appointed a professional management company as administrator; and

8.7.5 allowed membership to be promoted to the public.

8.8 The High Court in *Commercial Nominees* considered that there were three main indicators of the continuity of a trust relationship, being:

8.8.1 the constitution of the trust;

8.8.2 the trust property; and

8.8.3 the membership of the trust.

8.9 Substantial changes any of the above may cause a resettlement.

8.10 The High Court considered that, in order to destroy the necessary continuity, changes in one or more of the above indicators must be such as to terminate the existence of the entity, or to produce the result that the particular trust does not derive the income in question. It was held that the changes made to the trust deed in question were not sufficient to destroy the continuity, primarily because the fund was at all times governed by the same deed, the trust property did not change, and the members before the amendment to the trust deed remained members afterwards. We consider that the amendments discussed above will not cause a resettlement.

8.11 The Commissioner notes in the Statement that administrative changes, such as re-defining trust income (without more) may not cause a resettlement (depending on the context) as it may be administrative in nature.

8.12 However, regard will need to be given to the implications to the membership (i.e. the beneficial entitlements) of the trust, and what implications such an amendment will have on the respective entitlements in a trust. For example, an important consideration will be determining how unallocated / undistributed income is to be dealt with. For example, is such income:

8.12.1 accumulated, and form part of the corpus of the relevant trust estate;

8.12.2 is it distributed to certain default beneficiaries; or

8.12.3 is it held on trust for a specific purpose (e.g. a charitable purpose).

Changes in the Taxation of Trusts

A paper presented by Michael Bennett and Denis Barlin at the NSW Young Lawyers CLE

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Michael Bennett E bennett@sevenwentworth.com.au D 8224 3055 M 0408 029 416
Denis Barlin E dbarlin@wenworthchambers.com.au D 9231 6646 M 0404 848 311

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1. General overview

1.1 The income years ended 30 June 2010 and, more particularly, 30 June 2011 have been very active for the taxation of trusts. Significant events in three areas of trust taxplay activity:

1.1.1 decisions of the Courts and principally the High Court's decision in *Commissioner of Taxation v Bamford* (2010) 240 CLR 481; (2010) 264 ALR 436; [2010] HCA 10 ("**Bamford**");

1.1.2 legislative changes, principally:

1.1.2.1 the new rules set out in *Tax Laws Amendment (2011 Measures No. 5) Act* 2011 (Cth) (the "**Streaming Amendments**") that deal with taxation of franking credits and capital gains in trusts; and

1.1.2.2 the new rules set out in the *Tax Laws Amendment (2010 Measures No. 2) Act* 2010 (Cth) that are principally about Division 7A of Part III of the *Income Tax Assessment Act* 1936 (Cth) (the "**1936 Act**") and companies providing rights to use property, but also contain some trust issues (the "**Div 7A Amendments**"); and

1.1.3 Australian Taxation Office ("**ATO**") activities principally the very controversial draft ruling on unpaid present entitlements, TR 2009/D8.

1.2 Some of these changes have overtaken themselves. For instance, there was at the time – and this paper includes – a discussion of streaming post Bamford (see **heading 4** below). That discussion should be read as having been overtaken by the Streaming Amendments (see **heading 5**).

1.3 And what's more the change is not over. Chapter 2 of the explanatory memorandum to the Bill that introduced the Steaming Amendments makes it clear that the streaming provisions have been introduced as an interim measure to deal with perceived anomalies in the taxation of capital gains and franked distributions pending a comprehensive review of Division 6 of Part II of the 1936 Act.

1.4 The changes made so far give rise to issues themselves and further consequential issues for trusts. In addressing the issues – both outlined above and the consequential issues – this paper will discuss:

1.4.1 Taxation of trusts generally;

1.4.2 The competing views before Bamford;

1.4.3 The context of Bamford and what it means for trusts;

1.4.4 Briefly (as it is not germane to the other issues raised in the paper) what are the Div 7A Amendments and what they mean for trusts;

1.4.5 What are the Steaming Amendments and what they mean for trust;

1.4.6 What a trust deed needs in light of those three issues; and

1.4.7 Amending trust deeds to deal with those three issues.

1.5 The issues are dealt with in this order as they are chronological to their occurring.

2. Taxation of Trusts

2.1 The provisions dealing with the taxation of trust income are contained in Division 6 of Part III of the 1936 Act (which comprises of sections 95 to 102).

2.2 As a result of the enactment of Streaming Amendments, regard should also be given to:

2.2.1 Subdivision 207-B of the *Income Tax Assessment Act* 1997 (Cth) (the "**1997 Act**") – which deals with franking credits obtained by a trust estate; and

2.2.2 Subdivision 115-C of the 1997 Act – which deals with the distribution of capital gains by a trust estate.

2.3 Chief Justice Latham in *Tindal v FC of T* (1946) 72 CLR 608 at 618 observed that the object of Division 6 of the 1936 Act is to "*… secure payment of tax upon the whole of the net income of a trust estate, either from a beneficiary or the trustee, whether the income is paid over to or on account of the beneficiary …*". Further, according to Emmett J in *Bamford v Federal Commissioner of Taxation* (2009) 176 FCR 250 "*… an important assumption underlying Division 6 …* [is] *… that a beneficiary who derives a share of the net income should be in a position to pay out of that income; otherwise, the beneficiary could be placed in a difficult position*."

2.4 The starting point in determining the taxation of trust income is s 97 of the 1936 Act. Relevantly, s 97(1) of the 1936 Act 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; and

(b) the exempt income of the beneficiary shall include:

(i) so much of the individual interest of the beneficiary in the exempt income of the trust estate as is attributable to a period when the beneficiary was a resident; and

(ii) so much of the individual interest of the beneficiary in the exempt 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;

except to the extent to which the exempt income to which that individual interest relates was taken into account in calculating the net income of the trust estate; and

(c) the non-assessable non-exempt income of the beneficiary shall include:

(i) so much of the individual interest of the beneficiary in the non-assessable non-exempt income of the trust estate as is attributable to a period when the beneficiary was a resident; and

(ii) so much of the individual interest of the beneficiary in the non-assessable non-exempt 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]

2.5 That is, s 97 of the 1936 Act provides that where a beneficiary, who is not under a legal disability is presently entitled to a "*… share of the income of the trust estate …*", the assessable income of:

2.5.1 a resident beneficiary includes the beneficiary's share of the '*… net income of the trust estate …*'; and

2.5.2 a non-resident beneficiary includes so much of the beneficiary's share of the net income of the trust as is attributable to sources in Australia.

2.6 It should be noted that the term "net income of the trust estate" for the purposes of s 97 of the 1936 Act is defined in s 95(1) of the 1936 Act. However, the term "*… the income of the trust estate …*" as contained in s 97 of the 1936 Act is not defined in the 1936 Act.

2.7 Subsection 95(1) of the 1936 Act defines the term 'net income', in relation to a trust estate as:

> ***net income**, 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 Division 393 of the Income Tax Assessment Act 1997 (Farm management deposits) 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.*

2.8 For completeness, it should be noted that:

2.8.1 s 98 of the 1936 Act provides that the trustee is liable to tax on behalf of a beneficiary where the beneficiary is presently entitled to a share of the income of a trust estate, but the beneficiary is under a legal disability;

2.8.2 ss 99 and 99A of the 1936 Act apply to subject the trustee to tax where there is some part of the net income of a trust estate that is not subject to tax under either of ss 97 or 98 of the 1936 Act. The difference as between s 99 and s 99A of the 1936 Act is the rate of tax applicable. Typically, the trustee will be subject to tax under section 99A of the 1936 Act at a penal rate of tax equal to the maximum rate of tax (currently 45%). However, the Commissioner has a discretion to apply s 99 of the 1936 Act in certain circumstances, in which case the trustee will be subject to tax at the normal marginal rates of tax.

3. The two competing views before the decision in Bamford

3.1 There has been, for some time, two competing views in the taxation of trust income – the proportionate view and the quantum view.

Proportionate approach

3.2 *David & Anor v FC of T* 89 ATC 4377 contains an example of the application of the proportionate approach (which according to the High Court's decision in Bamford, is the correct approach).

3.3 The proportionate view looks to the share (or proportion) of trust law income of a trust to which a beneficiary is "presently entitled", and then applies that share or proportion to the net income of a trust estate to calculate how much of the net income is to be included in the beneficiary's assessable income.

3.4 As an example, if a beneficiary is entitled to one half of the trust law income, then the beneficiary must include half of the net income in their assessable income – irrespective of whether it is more or less than the amount of the trust law income to which they are entitled.

(a) Implications if tax law income exceeds trust law income

3.5 Under this approach, a beneficiary who is "presently entitled" to trust law income may be required under s 97(1) of the 1936 Act to include in their assessable income an amount of net income which is greater than the amount of trust law income to which they are entitled, and to which has been paid or distributed to them.

3.6 That is, they may be subject to tax on amounts whish they will not receive, and are not entitled to actually receive.

3.7 This outcome seems to be contrary to the objectives of Division 6 of the 1936 Act as outlined by Emmett J in the Full Court of the Federal Court decision in *Bamford v Federal Commissioner of Taxation* (2009) 176 FCR 250 (discussed above).

(b) Implications if trust law income exceeds tax law income

3.8 However, where the net income of a trust estate for the purposes of s 95(1) of the 1936 Act is less than the trust law income, then a beneficiary who is "presently entitled" pursuant to s 97(1) of the 1936 Act will be required to include in their assessable income an amount which is less than the trust law income to which they will be entitled, and which will be paid to them.

3.9 As a result, an on the assumption that the beneficiaries are "presently entitled" to the whole of the trust law income, with the result that the whole of the "net income" of the

trust estate is included in their assessable income pursuant to s 97(1) of the 1936 Act, there can be no part of the net income to which ss 99 or 99A of the 1936 Act applies.

3.10 There is still a question as to whether, in these circumstances, the beneficiary must include the excess amount (i.e. the amount not included under s 97(1) of the 1936 Act) under some provision of the tax acts (e.g. CGT event E4 as contained in s 104-70 of the 1997 Act).

The quantum approach

3.11 The quantum approach (which is no longer good law) is based on the proposition that a beneficiary can only be presently entitled to such amount(s) of trust income as they actually receive.

3.12 Further, any part of the net income of the trust estate which exceeds the amount to which the beneficiary is presently entitled is not income to which the beneficiary is presently entitled to pursuant to s 97 of the 1936 Act, with the result that the trustee is subject to tax on it under s 99A of the 1936 Act (unless the Commissioner exercises it discretion to cause it to be subject to tax under s 99).

3.13 As with the proportionate approach, where the net income of the trust estate for s 95(1) of the 1936 Act purposes is less than the trust law income, such that the beneficiary receives an amount which is greater than the amount included in their assessable income, the question arises as to how the excess is to be taxed (if at all).

4. Bamford

4.1 Bamford was a much anticipated decision. In the view of some[1] the decision was a missed opportunity to settle an area of the trust law and tax law that has been crying out for correction: *Bamford* at [17] citing Hill J in *Davis v Federal Commissioner of Taxation* (1989) 86 ALR 195 at 230.

Background to Bamford

4.2 Mr and Mrs Bamford were beneficiaries of a discretionary trust known as the Bamford Trust (the "**Trust**"). The trustee of the Trust was P&D Bamford Enterprises Pty Ltd. Mr and Mrs Bamford were also the directors and employees of P&D Bamford Enterprises Pty Ltd.

[1] Slater QC *Taxation Trust Income After* Bamfor'ds *Case*, 26th National TIA Convention, 2-4 March 2011

4.3 During the 2000 income tax year, the Trust made a contribution to an offshore superannuation fund on behalf of Mr and Mrs Bamford. The contribution was sourced from borrowings by the corporate trustee, in its capacity as trustee of the Trust.

4.4 For the purposes of determining the "net income" of the Trust for the 2000 income tax year, the corporate trustee (in its capacity as trustee of the Trust) claimed a deduction for both the contribution made to the offshore superannuation fund, and the interest on the borrowed funds used to make the contribution. The total deduction claimed was $191,701.

4.5 After taking into account of the deductions, the "net income" of the Trust for that year was distributed to specified beneficiaries of the Trust. Included in the distribution were Mr and Mrs Bamford, who both had specified amounts distributed to them.

4.6 Specifically, for that income tax year (i.e. the 2000 income tax year), the trustee of the Trust allocated amounts to certain beneficiaries of the Trust, including a payment of $34,000 each to Mr and Mrs Bamford. However, the trustee of the Trust did not have sufficient funds to pay the full amount of $34,000, and instead paid them $33,872, being what the trustee of the Trust thought was the total remaining trust funds.

4.7 The amount initially distributed by the trustee of the Trust was $187,530.

4.8 In 2005, the Commissioner of Taxation applied the anti-avoidance provisions so as to disallow the deductions of the Trust (for the 2000 income tax year) for the superannuation contribution and the interest. As a result of the denial of the deductions, for the purposes of the 2000 income tax year the Trust's taxable income exceeded its accounting income.

4.9 The decision essentially dealt with two things:

4.9.1 whether the 'proportionate approach' applied in the event that tax law income exceeds accounting / trust income; and

4.9.2 whether the trust deed of the trust could characterise an amount of capital gains as income of the Trust.

Application of the proportionate view

4.10 As a result of the denial of the deduction, the Trust's taxable income increased by $191,000. The Commissioner issued amended income tax assessments to both Mr and Mrs Bamford. Pursuant to the assessments, the Commissioner contended that Mr and Mrs Bamford were liable to tax on the increased 'net income' of the Trust based on the proportionate share of the amount by which the taxable income of the trust exceeded the accounting income.

4.11 Indeed, the Commissioner sought to assess Mr and Mrs Bamford on an extra $34,624, on the basis that that amount represented the 'share' of the additional $191,000 as their share (i.e. 18%) of the previous amount (i.e. $187,530) actually distributed.

4.12 However, the taxpayers argued that they should only be taxed on the difference between the $33,872 which they actually received, and the specific amount of $34,000 which was originally allocated to them (i.e. an amount of $128 each).

4.13 The High Court rejected the taxpayer's argument, and in doing so applied the "proportionate approach".

4.14 The High Court took a two step approach in dealing with this issue:

4.14.1 First – the High Court held that the term "*… income of the trust estate …*" as contained in s 97(1) of the 1936 Act refers to distributable income, being income as determined by the trustee taking into account the terms of the trust (e.g. the trust deed) and appropriate accounting principles.

4.14.2 Secondly – after ascertaining the "share" of the distributable income to which a beneficiary is presently entitled, s 97(1) of the 1936 Act then requires that "*… that share of the net income of the trust estate …*" be ascertained, being the shares of the taxable income and not the distributable income.

4.15 Further, it was held that the inclusion within s 97(1) of the 1936 Act of the defined phrase "*… net income of the trust estate …*" and the undefined term "*… the income of …* [the] *… trust estate …*" indicated that these were intended to have different meanings. As a result, the term "*… the income of …* [the] *… trust estate* " had a different and defined meaning for taxation purposes.

4.16 The Court at [45] held that the analysis of Sundberg J in *Zeta Force Pty Ltd v Commissioner of Taxation* (1998) 84 FCR 70 at 74-75 should be applied:

> *The resolution of the second issue of construction is to be found in the analysis by Sundberg J in* Zeta Force Pty Ltd v Commissioner of Taxation *… . His Honour dealt with the first issue of construction to the same effect as that just explained, saying:*
>
> > *"The words 'income of the trust estate' in the opening part of s 97(1) refer to distributable income, that is to say income ascertained by the trustee according to appropriate accounting principles and the trust instrument. That the words have this meaning is confirmed by the use elsewhere in Div 6 of the contrasting expression 'net income of the trust estate'. The beneficiary's 'share' is his share of the distributable income."*
>
> *Sundberg J then continued:*
>
> > *"Having identified the share of the distributable income to which the beneficiary is presently entitled, s97(1) requires one to ascertain 'that share of the net income of the trust estate'. That share is included in the beneficiary's assessable income. The expression 'net income of the trust estate' in par (a)(i) has the meaning given it by s 95(1) – taxable income as opposed to distributable income. The words 'that share' in par (a)(i) refer*

back to the word 'share' in the expression 'a share of the income of the trust estate', and indicate that the same share is to be applied to an income amount calculated according to a different formula (taxable income as opposed to distributable income). Since the income amount may differ according to which formula is applied, the natural meaning to give to 'share' where it appears for the second time is 'proportion' rather than 'part' or 'portion'. When Parliament wanted to convey the latter meaning, as it did in ss 99 and 99A, it used the word 'part'.

The contrast between the expressions 'share of the income of the trust estate' and 'that share of the net income of the trust estate' shows that the draftsman has sought to relate the concept of present entitlement to distributable income, and not to taxable income, which is, after all, an artificial tax amount. Once the share of the distributable income to which the beneficiary is presently entitled is worked out, the notion of present entitlement has served its purpose, and the beneficiary is to be taxed on that share (or proportion) of the taxable income of the trust estate."

4.17 For the 2000 income year, the "net income" of the Trust included the amount of $191,701 which should not have been claimed as a deduction in the tax return of the Trust. As a result, the High Court held that the assessable income of Mr and Mrs Bamford should include a share of that amount, equivalent to the share they each received of the distributable income.

Whether the trust deed could re-characterise amounts

4.18 The trust deed of the Trust gave the trustee the discretion to determine whether a particular receipt should be treated as income or capital.

4.19 The trustee relied on this power to pass a resolution to distribute the first $60,000 of net income, "*… including …* [the] *…. capital gain …*" to Mr and Mrs Bamford in equal shares.

4.20 The Commissioner argued that the capital gain was not income of the Trust. Further, since there was no income, no beneficiary could be 'presently entitled' to the amount in question, the trustee of the Trust should be assessed at the special rates.

4.21 The High Court held that the term "income" as contained in s 99A of the 1936 Act should be interpreted as income of the trust estate, as understood in trust law.

4.22 As a result, the net capital gain of the Trust became the income of the Trust after the trustee exercised its discretion to characterise the capital gain as income of the Trust.

Outcome for Trust Distributions

4.23 There is no room for doubt that Bamford establishes that:

4.23.1 income of the trust estate identified in s 97(1) of 1936 Act is to be determined according to any directions set out in the Trust Deed;

4.23.2 the share of the net income attributable to a beneficiary is to be determined in the same proportions in which the beneficiary enjoys the present entitlement to the share of the income of the trust.

4.24 In this first regard, the Court made it clear that the general rules regarding apportionment between capital and income of receipts and outgoings was largely based on assumptions which could be displaced by the terms of the trust instrument: Bamford at [17]. The general law of trusts operates to give meaning to the term "the income of the trust estate".

4.25 The determination of present entitlement to a share of the income is a process of trust administration. The decision of the Full Court of the Federal Court in *C of T v Totledge Pty Ltd* (1982) 40 ALR 385 at 393 is quoted in support: Bamford at [39]. The High Court distinguished its own decision in *C of T v Australia and New Zealand Savings Bank Ltd* (1998) HCA 53 (Bamford at [39]) as not relevantly addressing the issue. Finally, the Court observed that the Commissioner's lack of consistency in wishing to exclude "statutory income" from "income of the trust estate" did not assist his argument that "income" means "income according to ordinary concepts": Bamford at [41].

4.26 On the meaning of the term "share of the net income" the High Court adopted the proportionate approach advocated by Sunberg J in *Zeta Force* (discussed above).

4.27 What does this translate into for trustees making decisions in respect of trust distributions for the 2010 income year?

4.28 There are a number of relevant observations to be made.

4.29 First, if the Trust Deed provides a formula for determining the income of the trust then that formula will determine the entitlement of the beneficiaries to income. If, for example, the Deed contains words to the following effect:

> *"The net income of the trust is an amount equal to the amount determined in accordance with subsection 95(1) of the* Income Tax Assessment Act 1936 *but reduced by any amount which would otherwise be included by application of Division 207 of the* Income Tax Assessment Act 1997*".*

4.30 Throughout this paper "subsection 95(1) terms" means an amount adjusted for the franking credit gross up. The issue of grossing up is considered below in the context of using the full tax exemption including the franking rebate available to children.

4.31 Leaving aside the elimination of any gross up for franking credits (which itself is affected by the Streaming Amendments as discussed below) the amount of net income for trust law purposes

will equal the tax law income. The two will coincide so that there should, in the ordinary course, be no amount assessable to the trustee under s 99A of the 1936 Act.

4.32 Secondly, if the Trust Deed is silent then "ordinary income" principles apply. Just what they are is difficult to say. The ATO has expressed the view that income of a trust is income according to ordinary principles. This is not the same thing as accounting income determined in accordance with accounting principles. It requires a dissection of receipts into:

4.32.1 income according to ordinary principles;

4.32.2 income which is not ordinary income;

4.32.3 capital receipts.

4.33 Following that dissection, the expenses must be apportioned accordingly.

4.34 This is, of course, all too much. Many trust deeds will have a clause like that in Bamford which allows the trustee to determine whether a receipt is capital or income. Others will have very broad powers allowing the trustee to determine the basis on which income of the trust is to be worked out.

4.35 If these powers exist they should be used to avoid uncertainty brought about by the "ordinary income" approach. If they do not exist then the deed should be to give the trustee such a power. Whether such an amendment will amount to a resettlement, which might have adverse capital gains tax (and stamp duty) consequences, is discussed at **paragraphs xx** below.

4.36 Thirdly, because the proportionate approach has prevailed, a strict application of that rule will mean that great care needs to be taken when seeking to direct a specific amount of tax law net income to a particular beneficiary with absolute certainty e.g. the maximum amount to a child which escapes the punitive rates under Division 6AA of the 1936 Act. This issue is illustrated in the Examples which follow.

4.37 Fourthly, the High Court decision says nothing about streaming of trust income. The matter was not in issue. The uncertainty about streaming of income according to its character remained unabated, until the Streaming Amendments.

4.38 Finally, the ATO has done away with the benevolent "capital beneficiary" approach set out in Practice Statement PSLA 2005/1 (GA) on and from 13 October 2010.

Examples

4.39 The best way to illustrate these points is by way of example. In the examples which follow the following facts apply in relation to the A Family Trust for the income year ended 30 June 2010:

Receipts:

rent	$50,000
net capital gain	$100,000

Expenses:

rental expenses	$10,000
interest	$20,000

4.40 The interest relates to the rental property only. The discountable capital gain was made on the sale of shares in a listed company. The intended beneficiaries are Mr and Mrs A and their two children both under 18.

4.41 Because of the low income rebate the following no-tax thresholds apply to minors:

Income Year end 30 June	**$**
2010	3,000
2011	3,333

4.42 If the income constitutes fully franked dividends the cash payment thresholds and grossed up taxable income amounts are:

Income Year end 30 June	**$ cash**	**$ taxable income**
2010	6,300	9,000
2011	7,000	10,000

4.43 These figures have considerable significance for trustees seeking to hit the no tax "sweet spot" for a distribution to a child.

(a) Subsection 95(1) terms apply – no "balance approach"

4.44 The taxable capital gain is $50,000. Accordingly, the distributable trust income is $70,000.

4.45 For 2010 a minor may be distributed $3,000 with no tax liability if entitled to the low income rebate (see comments above).

4.46 The trust distribution minutes might give effect to the following:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000

70,000

4.47 The tax law results will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.48 The cash in the trust will include the $50,000 covered by the 50% general CGT discount. This is not income and can be dealt with as capital. As this is a discretionary trust it can be distributed without tax consequences.

(b) Ordinary income applies – no "balance approach"

4.49 In this instance the trust distribution minutes will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	7,000
Mr A	7,000
	20,000

4.50 The tax law results will be:

	$
Child 1	$3{,}000 + {}^{3,000}/_{20,000} \times \$50{,}000$
Child 2	$3{,}000 + {}^{3,000}/_{20,000} \times \$50{,}000$
Mrs A	$7{,}000 + {}^{7,000}/_{20,000} \times \$50{,}000$
Mr A	$7{,}000 + {}^{7,000}/_{20,000} \times \$50{,}000$

4.51 The final results:

	$
Child 1	10,500
Child 2	10,500
Mrs A	24,500

Mr A	24,500
	70,000

4.52 This is a strict application of the proportionate approach.

4.53 Each of the children will pay tax on $7,500 at the Division 6AA punitive rates of 45%. This is not a good result.

(c) Subsection 95(1) applies – "balance approach" used

4.54 Trust minutes:

	$
Child 1	3,000
Child 2	3,000
Mrs A	half of the balance
Mr A	half of the balance

4.55 Trust income entitlements:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.56 The tax law result:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.57 This is the same outcome as where no "balance approach" is applied – but see below for the effect of a tax adjustment.

(d) Ordinary income applies – "balance approach" used

4.58 Trust minutes

	$
Child 1	3,000
Child 2	3,000
Mrs A	half of the balance
Mr A	half of the balance

4.59 Trust income created will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	7,000
Mr A	7,000
	20,000

4.60 The tax law results will be:

	$
Child 1	$3{,}000 + {}^{3,000}/_{20,000} \times \$50{,}000$
Child 2	$3{,}000 + {}^{3,000}/_{20,000} \times \$50{,}000$
Mrs A	$7{,}000 + {}^{7,000}/_{20,000} \times \$50{,}000$
Mr A	$7{,}000 + {}^{7,000}/_{20,000} \times \$50{,}000$

4.61 The final results:

	$
Child 1	10,500
Child 2	10,500
Mrs A	24,500
Mr A	24,500
	70,000

4.62 Again there is no difference. However, the "balance approach" is more realistic because it is unlikely that the trust income or tax law income will be known as at any 30 June. In reality these figures are not known until the accounts are drawn later in the calendar year.

(e) Tax Law Adjustments

4.63 It is often important to anticipate an adjustment to the trust's tax law income especially where there is something contentions going on.

4.64 As has been seen the tax law result will follow on a proportionate basis the entitlements to income created under the Deed. To test the outcome it is assumed in the above examples that the trustee failed to recognise $10,000 of rental income (say the trustee at first considered that the income was to be deferred until the 2011 income year) but was in fact wrong about this.

4.65 How do the various approaches deal with such an adjustment?

Example (a) – subsection 95(1) applies (but no "balance approach")

4.66 The trust law entitlements and tax law results were the same:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.67 The tax law adjustment will increase both the trust law entitlement and the tax law income by $10,000. The Trustee has not dealt with this $10,000 and, without an operative default beneficiary clause, it will be assessed to the Trustee under section 99A of the 1936 Act.

4.68 The trust law entitlements and tax law result will be:

	$
Child 1	3000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
Trustee	10,000
	80,000

4.69 However, if there is no streaming of the capital gain (with the effect that all beneficiaries are entitled to a proportionate part of the capital gain) that part of the capital gain reflected in the income to which no beneficiary is presently entitled will be grossed up for the loss of the 50% general CGT discount. Five eighths of the $10,000 adjustment assessed to the Trustee is capital gain. As a result the share of the net income assessable to the Trustee will be increased by $6,250.

4.70 The final result will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
Trustee	16,250
	86,250

4.71 This is a costly outcome.

Example (c) – subsection 95(1) but using a "balance approach".

4.72 The trust law entitlement and tax law result were the same.

	$
Child 1	3,000
Child 2	3,000
Mrs A	half of the balance
Mr A	half of the balance

4.73 The unadjusted result was:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.74 The adjusted trust law entitlement and tax law result will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000 + 5,000
Mr A	32,000 +5,000
	80,000

4.75 The "balance approach" together with adoption of s 95(1) terms directs all of the tax law result from an adjustment made by the ATO to the balance beneficiaries.

4.76 If the balance distribution has been used Mr and Mrs A will "enjoy" a further $5,000 of income entitlement (it now having been correctly determined) and a further $5,000 of tax law net income each. No amount will be assessed to the trustee.

4.77 There is an argument that the beneficiaries have not become presently entitled to the amount of the adjustment to the trust law net income as it was not ascertained at the end of the income year. In the writer's opinion the trust law net income was always the amount as correctly adjusted by the ATO. There was never any uncertainty about it. It is simply the case that the trustee and ATO had not properly determined the correct quantum of income.

4.78 In practical terms how have the Courts looked at the "balance approach"? It has not come up that often.

4.79 The decision of Cooper J in *BRK (Bris) Pty Ltd v C of T* [2001] FCA 164 might at first blush give cause for concern. There the Court considered the operation of the default beneficiary clause in the Trust Deed. The distributions had been:

1993 income year:

"Hendon Unit Trust 100%

and Resolved that should the Commissioner of Taxation disallow any amount as a deduction or include any amount in the assessable income of the Trust, such amount or amounts are to be deemed distributed on 30th June 1993 in the same proportions as listed above to the beneficiaries listed above".

1994 income year:

(a) The sum of $304,021.72 to Westside Commercial Centre Pty Ltd as trustee of the Hendon Unit Trust for its absolute benefit.

(b) The following sums to the following beneficiaries for their absolute respective benefits: NIL

(c) The Balance to Jessica Wagner and Bill Wagner equally between them for their absolute benefit.

1995 income year:

Hendon Unit Trust	*First $220,000*
Northbourne Trust	*Next $100,000*

Wilhelm J Wagner and Jessica O Wagner	*Remainder of balance equally*

4.80 The same "variation of income" clause as in 1993 applied in this year.

4.81 It would appear that the Trust Deed did not adopt subsection 95(1) terms and that income was ordinary income.

4.82 It was found that the Hendon Unit Trust was not an object of the Trust and the distribution of income to it failed. The default beneficiaries clause distributed income in default of appointment to the beneficiaries described in the Schedule to the Deed as tenants in common. This was the usual wide class of family objects.

4.83 The Court concluded that the default beneficiary clause did not operate as at 30 June because the trustee had a reasonable time after the end of the income year in which to decide to distributed or accumulate.

4.84 The question arose as to whether the balance clause in the 1994 and 1995 determinations operated to take the amounts which the Trustee had attempted to distribute to the Hendon Unit Trust to Mr and Mrs Wagner. It was concluded that this was not the effect of the distribution minute and, as a result, the Trustee was assessable under section 99A.

4.85 At [40] Cooper J concluded:

> *"In my judgment the submission is misconceived. In the 1994 income year the clear intention of the applicant was to appoint to Mr and Mrs Wagner only so much of the Trust income, if any, as exceeded $304,021.72 in addition to any income in excess of that amount in the event that the appointment to WCC should fail. The position is no different in respect of the 1995 year. The trustee purported to appoint discrete amounts of income to the Hendon Unit Trust as to the first $220,000 and to the Northbourne Trust as the next $100,000. Finally, as to any remainder after the application of the first $320,000 of income, that remainder was to be appointed to Mr and Mrs Wagner; they did not as a matter of construction or intention on the part of the trustee, take by default all of the income in the event of failure of the other two appointments."*

4.86 Rather than being a cause for concern about the "balance approach" the decision of Cooper J on this point supports its operation. The specific quantum entitlements fix the income (and tax where s 95(1) terms apply) at the amount specified in the Trustee's determination. If the gift fails it does not flow to the balance beneficiary but to the default beneficiary or, in the alternative, there is no such entitlement created, giving rise to a s 99A assessment to the trustee.

4.87 Further comfort can be obtained from observations made in *C of T v Ramsden* [2005] FCAFC 39. In that case the Court was concerned with the issue whether a beneficiary had effectively renounced a distribution of income.

4.88 The distribution minutes for the 1996 income year provided:

"Steve Hart Family Holdings No.2	*$17,295*
Steve Hart Family Holdings No.3	*$6,639*
Unlimited Aerobatic Discretionary Trust	*$34,810*
The Adcock Practice Trust	*$429,000*
Troy B Hart	*$4,750*
Steven I Hart	*The Balance"*

4.89 It was agreed that the Adcock Practice Trust did not qualify as a beneficiary. The default beneficiary clause provided for income which had not been appointed prior to year end to be held for Steven Hart and his three children as tenants in common. The ATO assessed each of the default beneficiaries to one quarter of the amount which had failed to be appointed to the Adcock Practice Trust.

4.90 The argument was pressed before the primary judge that the income should pass by way of the balance distribution to Steven Hart: Ramsden at [38] to [41]. Justice Spender's rejection of this argument was confirmed by the Full Court. It was observed at [2005] FCAFC 39 at [72]:

> *"We agree with this construction. 'The Balance' does not include the amounts which precede "The Balance" in the resolution of 30 June 1996.*
>
> *'The Balance' is the Income of the Trust for the year ended 30 June 1996 other than the amounts which precede it in the resolution in question, whether effectively appointed or not".*[2]

4.91 This observation supports the "balance approach" taken in this paper where there have been effective distributions. Note, however, that it will not work where a distribution is ineffective. In such a case the adjustment will be assessed to the default beneficiary, if there is one, or to the trustee.

Example (d) – Ordinary Income with balance approach applying

4.92 The trust law entitlements were:

	$
Child 1	3,000

[2] [2005] FCAFC 39 at para. 72.

Child 2	3,000
Mrs A	half of the balance
Mr A	half of the balance

4.93 Trust income entitlements:

	$
Child 1	3,000
Child 2	3,000
Mrs A	7,000
Mr A	7,000
	20,000

4.94 The tax law result was:

	$
Child 1	10,500
Child 2	10,500
Mrs A	24,500
Mr A	24,500
	70,000

4.95 When the tax law income is adjusted by $10,000 there is no change to the trust law result. The tax law result will be:

	$
Child 1	$10,500 + {}^{10,500}/_{70,000} \times \$10,000$
Child 2	$10,500 + {}^{10,500}/_{70,000} \times \$10,000$
Mrs A	$24,500 + {}^{24,500}/_{70,000} \times \$10,000$
Mr A	$24,500 + {}^{24,500}/_{70,000} \times \$10,000$

4.96 The final result will be:

	$
Child 1	12,000
Child 2	12,000
Mrs A	28,000
Mr A	28,000

	80,000

4.97 The result has only become worse from a Division 6AA income perspective.

Will a "default beneficiary" clause in the Deed assist?

4.98 An income default beneficiary clause would be expressed something like:

> *"If the Trustee has not determined to distribute all of the net income of the Trust by the end of the Income Year the Income Default Beneficiary will be absolutely entitled to that part of the net income which has not been distributed."*

4.99 The term "Income Default Beneficiary" will be appropriately defined to identify individuals or companies.

4.100 In Example (a) – subsection 95(1) terms but no "balance approach" – a default beneficiary clause would have deflected the tax adjustment from the trustee to the default beneficiary.

4.101 In Example (b) – ordinary income but no "balance approach" – the default beneficiary clause would have no effective operation as all of the trust law/tax law income has been accounted for.

4.102 The trust entitlements were:

	$
Child 1	3,000
Child 2	3,000
Mrs A	7,000
Mr A	7,000
	20,000

4.103 The tax law result was:

	$
Child 1	10,500
Child 2	10,500
Mrs A	24,500
Mr A	24,500
	70,000

4.104 If the tax law income is increased by $10,000 the trust law income does not alter. The tax law adjustment is apportioned according to the trust law income apportionments, as follows:

	$
Child 1	10,500 + $^{3,000}/_{20,000}$ x 10,000
Child 2	10,500 + $^{3,000}/_{20,000}$ x 10,000
Mrs A	24,500 + $^{7,000}/_{20,000}$ x 10,000
Mr A	24,500 + $^{7,000}/_{20,000}$ x 10,000[3]
	70,000

4.105 The final tax results will be:

	$
Child 1	12,000
Child 2	12,000
Mrs A	28,000
Mr A	28,000
	80,000

4.106 In Example (c) – subsection 95(1) terms and a "balance approach" – the default beneficiary clause has no role to play because the adjustment will always be directed to the balance beneficiary.

4.107 In Example (d) – ordinary income and "balance approach" – the default beneficiary clause has no need to operate because the tax adjustment will simply be apportioned in accordance with the trust law entitlements which don't change.

Summary re Tax Adjustments

Trust Accounting Basis	Tax Law Income	Trust Income	Adjustment to (if no default beneficiary)	Adjustment to (if there is a default beneficiary)
subsection 95(1) – no "balance approach"	+ $100	+ $100	Trustee	Default Beneficiary
subsection 95(1) – "balance approach"	+ $100	+ $100	Balance Beneficiaries	Balance Beneficiaries
ordinary income – no "balance approach"	+ $100	no change	All Beneficiaries	All Beneficiaries
ordinary income – "balance approach"	+ $100	no change	All Beneficiaries	All Beneficiaries

[3] The proportions remain the same whether the trust law or tax law results are used.

Guidance from Bamford

4.108 As the High Court observed in Bamford at [17]:

> *"… both sides in argument on the present appeals accepted that whichever of the competing constructions of Div 6 were accepted examples could readily be given of apparent unfairness in the resulting administration of the legislation"*

4.109 In reaching the conclusion that the terms of the Trust Deed determine the trust income to which a beneficiary may be made entitled the High Court has gone very far towards resolving most of the problems and uncertainties which confronted practitioners and the trustees and beneficiaries they advise. With a good understanding of the terms of the Trust Deed as they effect trust distributions most distribution problems can be addressed.

4.110 As has been demonstrated in the above worked examples adopting a s 95(1) terms plus "balance approach" achieves the following:

4.110.1 the quantum of tax distribution to children can be locked in.

4.110.2 any "normal" tax adjustment will flow to the balance beneficiaries.

4.110.3 if used in conjunction with a default beneficiary clause ineffective distributions can also be dealt with.

4.111 The subsection 95(1) but without a "balance approach" can lead to:

4.111.1 an assessment of the tax adjustments to the trustee under section 99A;

4.111.2 clawback of any general CGT discount.

4.112 This can be addressed by using a default beneficiary (of course the default beneficiary should not be a company where the general CGT discount is involved).

4.113 The balance approach together with a considered default beneficiary is to be preferred as the outcome is more predictable.

4.114 The ordinary income approach is problematic because it is:

4.114.1 too difficult to calculate what is net ordinary income;

4.114.2 and tax law adjustments will be spread across all beneficiaries (as there is no adjustment to the net income).

5. Div 7A Amendments

5.1 Division 7A of Part III of the 1936 Act deals with accessing wealth in private companies without accounting for the tax that would otherwise be payable on the value accessed. It focuses on three means of accessing wealth in private companies – payments from a private company, loans from a private company or the forgiveness of a debt by a private company to an associate of that company.

5.2 In 2010 there were two broad changes to the Division 7A interacts with trusts:

5.2.1 The Div 7A Amendments; and

5.2.2 The Commissioner's position in *Taxation Ruling 2010/3* and *Practice Statement Law Administration* 2010/4.

5.3 The changes to Division 7A include the insertion of an introductory note to Division 7A stating:

> An amount may also be included in the assessable income of a shareholder or shareholder's associate if:
>
> (a) a company has an unpaid present entitlement to income of a trust; and
>
> (b) the trustee makes a payment or loan to, or forgives a debt of, the shareholder or associate.
>
> (See Subdivisions EA and EB.)

5.4 This note is of interest as it strongly suggests that Subdivision EA is a 'code' which is intended to capture arrangements where there is an unpaid present entitlement subsisting between a trust and a corporate beneficiary and there is then a loan, payment or forgiveness that occurs between the trustee and a shareholder or an associate of a shareholder in the corporate beneficiary.

5.5 This should be contrasted with the position in the ATO *Taxation Ruling* 2010/3 where the ATO assert that subdivision EA has much more limited effect, where they generally restrict its operation to the situation where there is a sub-trust in existence between a trustee and a corporate beneficiary and there is then loan, payment or forgiveness involving a shareholder or an associate of a shareholder and the trustee of the sub-trust.

5.6 In the 31 March 2010 NTLG meeting the professional bodies questioned the ATO as to whether the introduction of this provision into Division 7A cast doubt on the position in their draft ruling. The meeting agenda includes the following discussion:

> The ATO does not see a conflict between the legislation of provisions dealing with unpaid present entitlements and the position set out in Draft Ruling TR 2009/D8.

This is because, contrary to the premise of the question, under Draft Ruling TR 2009/D8 unpaid present entitlements will retain that status for Division 7A purposes in many situations, including where:

- the amount representing the UPE is physically held on sub-trust for the sole benefit of the private company beneficiary;
- the amount representing the UPE is being used by the trustee but all benefits from this use are held for the sole benefit of the private company; or
- the private company beneficiary is not aware and cannot be taken to be aware that the funds representing its UPE are being used for the potential benefit of any or all discretionary objects of the trust (rather than being physically set aside or used for its sole benefit).

The ATO has appropriately consulted with Treasury prior to and during the drafting of TR 2009/D8.

Provisions within Division 7A dealing with unpaid present entitlements will continue to have their intended application and there is no inconsistency between the Exposure Draft legislation and the draft Ruling.

Use of assets

5.7 As was announced in the 2009/10 Federal Budget the use of assets owned by private companies, or owned by trusts where there is a present entitlement owing to a private company may be subject to tax after 1 July 2009.

5.8 The way in which the use of assets will become subject to tax is through the amendment of the definition of the term 'payment' in Division 7A so that it extends to the provision of an asset (other than a transfer of property) for use by an entity. Consistent with the present operation of Division 7A the provision of the asset will only result in Division 7A consequences where the asset is provided to a shareholder or associate of a shareholder.

5.9 For the purposes of Division 7A the payment will occur when the use of the asset occurs.

5.10 A payment will also arise however where the asset is not used, but is available for use. The examples in the EM are illustrative of when it will be the right to use the asset, and not its use, that is subject to the Division 7A rules.

> ***Example (right to use from EM)***
> ***Brian is a shareholder of a private company that owns a luxury yacht. He does not have a formal agreement with the company in relation to the yacht, however, he takes the yacht out every second weekend.***
>
> ***Brian keeps the yacht at the company's business premises, but takes the key home. Brian stores several personal items on the yacht.***
>
> ***Brian's fortnightly use of the yacht is a payment under Division 7A. The availability of the yacht for Brian's use is also subject to Division 7A because the yacht is not readily available for use by the company. The company would need to arrange with Brian to***

get the key and for the removal of Brian's personal items before using the yacht. That is, the asset is available for Brian's use to the exclusion of the company.

Example (use from EM)
Marina is a shareholder of a private company that owns a city apartment. The apartment is generally available for rent. However, Marina asks the company not to rent the apartment out for a week so that she and her family can use the apartment over a long weekend. Marina's use of the apartment is a payment for the purposes of section 109CA.

5.11 An issue that arose on consultation over the draft legislation giving effect to these changes was whether the mere availability of assets to a shareholder or associate would result in the shareholder or associate being treated as having the asset available for their use. The EM again includes an example where there a payment is not taken to arise where an asset is available as a result of a general entitlement to use an asset without actual use of the asset.

Example (mere entitlement from EM)
Peter is a shareholder of a private company that owns five cars for company use. Shareholders and their associates have general permission to use the cars on weekends if they are not being used for company business. Peter regularly takes one of the cars home.

Peter's use of the car that he takes home will be subject to Division 7A. This will include driving the car (actual use) and the availability of the car for his use to the exclusion of the company, such as when it is parked at home, or at a restaurant that Peter is visiting.

Although Peter may have general permission to use all five of the cars, he does not use all of them for the purposes of Division 7A. The four cars that Peter leaves at the company premises are available for the company to loan to another shareholder, employee, customer, or other party. That is, these cars are not available to Peter to the exclusion of the company.

5.12 The EM also includes examples of where an asset is available to more than one shareholder or associate and it is necessary to determine who is taxed. The EM suggests and apportionment of the taxable value to the person who is the real recipient of the benefit. One example sets out that a minor that benefits should not be taken to receive a Division 7A payment, where another sets out that incidental use by a spouse of a vehicle provided to a shareholder would not result in the spouse being taxed on the benefit provided.

5.13 In valuing the payment taken to be made it will be the amount that would have been paid for the use of the asset in an arm's length dealing less any consideration paid that will be determined to be the payment for Division 7A purposes.

5.14 There are a number of exceptions from the payment provisions applying, including one not previously announced dealing with residential property:

5.14.1 Minor benefits – if the provision of the asset would have been a minor benefit under section 58P of the FBTAA had it been provided to an employee then the benefit will be disregarded for Division 7A purposes

5.14.2 Otherwise deductible payments – if a once off deduction would have been available to the shareholder or their associate in connection with the use of the asset then there will be no benefit to be taken into account for Division 7A purposes.

5.14.3 Dwellings – the use of a dwelling can be exempt where the following conditions are satisfied:

5.14.3.1 the entity or their associate is carrying on a business;

5.14.3.2 the entity or their associate uses or is granted or has a lease, licence or other right to use land, water or a building for the purpose of carrying on the business; and

5.14.3.3 the provision of the dwelling to the entity is connected with that use or with that lease, licence or other right to use the land, water or building to carry on the business.

5.14.4 Main residences – the provision of a dwelling that is a person's main residence does not result in a Division 7A payment where:

5.14.4.1 The provider of the dwelling is a private company;

5.14.4.2 The private company acquired the dwelling before 1 July 2009; and

5.14.4.3 The private company would pass COT from the time that the dwelling was acquired until the end of the time that a payment could be taken to be made under Division 7A.

5.14.5 Vacant land – if the exception for a dwelling or a main residence applies, it will extend to adjacent land in the same way as occurs in the main residence exemption.

Corporate limited partnerships

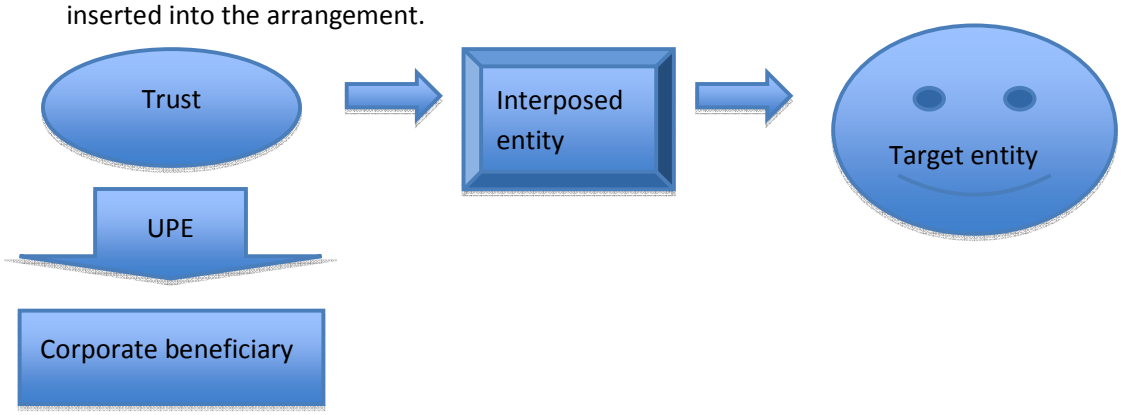
5.15 Closely held corporate limited partnerships (limited liability partnerships) will also now be subject to Division 7A. A corporate limited partnership will be closely held where it has fewer than 50 members or where an entity has, directly or indirectly, for the entity's own benefit, an entitlement to 75% or more of the income and capital of the partnership.

Interposed entities

5.16 The Div 7A Amendments fix two drafting issues in relation to the use of interposed entities.

5.17 The Division 7A legislation as originally drafted allowed for a payment by a private company through an interposed entity to be treated as a payment for Division 7A purposes.

5.18 The legislation did not however on a plain reading, allow for a trust where there was an unpaid present entitlement, to be deemed to have made a payment where an interposed entity was inserted into the arrangement.



5.19 A payment from the trust through an interposed entity to a target entity will now be caught by Division 7A if a reasonable person would consider that a loan or payment made to the interposed entity was made to enable a loan or payment to be made by the interposed entity to the target entity.

5.20 Consistent with the current operation of Subdivision EA however, a payment through to the target entity will only result in a Division 7A deemed dividend if it is referable to a reduction in a present entitlement that is in itself attributable to an unrealised gain in the trust.

5.21 The Div 7A Amendments also ensures that where an unpaid present entitlement is owed to a company by a trust, but the loan, payment or forgiveness that occurs does not involve the trust that owes the unpaid present entitlement, that Subdivision EA still has effect.

5.22 Subdivision EA will apply to treat a loan or payment from a trust as being a Division 7A loan or payment to the extent that the loan or payment is referable to an unpaid present entitlement owed to a private company where that amount has not already resulted in a Division 7A loan or payment.

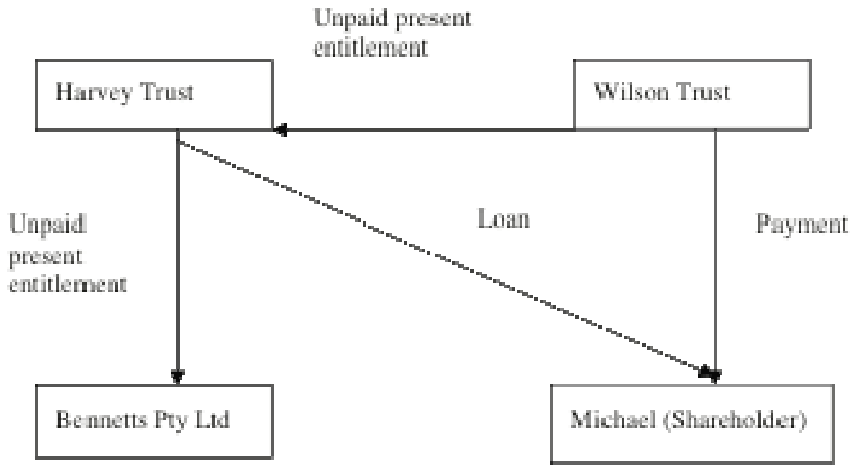
Example (interposed trust from EM)
Michael is a shareholder of Bennetts Pty Ltd and Bennetts Pty Ltd is a beneficiary of Harvey Trust. In the 2009-10 income year, Michael receives a payment from the trustee of the Wilson Trust, which is attributable to an unrealised gain. He receives this payment

because of his shareholding in Bennetts Pty Ltd. Michael also receives a $2,000 non-compliant Division 7A loan from the Harvey Trust.

Bennetts Pty Ltd is not presently entitled to an amount from the net income of the Wilson Trust. However, Bennetts Pty Ltd is entitled to $10,000 from the net income of the Harvey Trust (the first interposed trust) and Harvey Trust is presently entitled to $10,000 from the net income of the Wilson Trust. These amounts remain unpaid.

The loan made by the Harvey Trust to Michael will be included in Michael's assessable income under ordinary operation of subsection 109XA(2).

Bennetts Pty Ltd is taken to be presently entitled to $8,000 from the Wilson Trust, which is the unpaid present entitlement of $10,000 from the Harvey Trust, reduced by the $2,000 loan amount that is included in Michael's assessable income under another provision of Subdivision EA.



Loan back arrangements

5.23 Subdivision EA as currently drafted only captures payment arrangements where the payment is a reduction of a present entitlement that is referrable to an unrealised gain.

5.24 To circumvent these rules, apparently it had been suggested that the following arrangement could be entered into:

5.24.1 An unpaid present entitlement exists to a private company, say of $100,000.

5.24.2 A payment is made by the trustee of the trust to a beneficiary of an amount far in excess of the UPE, for example $1 million.

5.24.3 The amount in excess of the UPE is then loaned back to the trustee, being $900,000.

5.24.4 Thus, the beneficiary now has a credit loan of $900,000.

5.24.5 In future years the trustee appoints income to the company and uses the funds to repay the credit loan.

5.25 The need for there to be a payment referrable to a reduction of an unrealised gain will be removed where the payment made to a beneficiary is in reduction of a loan made on or after 1 July 2009 where a reasonable person would conclude that the trustee obtained the loan in order to make the payment.

Amendment to distributable surplus definition

5.26 The definition of distributable surplus will be amended so that amounts that have been deemed to be dividends as a result of the operation of Subdivision EA will be removed from the distributable surplus (by being correctly included as non-commercial loans).

Forgiveness of 109XB loans

5.27 There is a drafting problem that will be rectified so that the forgiveness of a loan by a trustee that has already been deemed to be a dividend will not result in a subsequent dividend. The law already applies in this way to the forgiveness of a debt owed to a private company by a shareholder that has already been deemed to receive a dividend under Division 7A.

Dividend set-off

5.28 Another drafting problem dealing with dividend set-offs will also be rectified.

5.29 At present, where a private company makes a loan that is deemed to be a dividend and later pays an unfranked dividend that is set off against that loan the later dividend is not included in assessable income.

5.30 The ability to disregard the later dividend does not apply where the loan was made by the trustee of a trust and where the deemed dividend arose under section 109XB.

5.31 The ability to disregard a later unfranked dividend offset against a loan from a trustee is being introduced.

Setting off employment entitlements

5.32 Another unusual aspect of the interaction of Division 7A generally and Subdivision EA has been that employment related payments that are offset against loans by trustees do not count as repayments if there is a borrowing of a similar or greater amount to the amount repaid. This is in contrast to setting off such a payment against a loan by a company where the repayment is taken into account even if there is a further borrowing.

5.33 This anomaly is to be rectified.

Borrowing to repay

5.34 Under the previous law a repayment is disregarded where the repayment is made where a reasonable person would conclude the repayment was made in order to borrow a similar or greater amount. This prevents a person from borrowing funds during a financial year, repaying on 30 June, and then reborrowing the amount on 1 July.

5.35 While the law has operated in this way (with some exceptions for repayments that occur by way of offsetting assessable amounts such as the wages noted above) it arguably has not operated where, instead of repaying to borrow, a person borrows to repay. This was be remedied so that a borrowing to repay will also activate section 109R.

> ***Example (from EM)***
> ***Alicia obtains a loan of $10,000 from Cleary Pty Ltd. Alicia has until the lodgment day to repay the loan. Two weeks before the lodgment day Alicia obtains a further $10,000 from Cleary Pty Ltd. She then repays the original $10,000 loan a week before the lodgment day.***
>
> ***The repayment of the original $10,000 loan is not a repayment for the purposes of section 109D, because Alicia has borrowed a similar amount from Cleary Pty Ltd and in this case a reasonable person would conclude that the loan was obtained in order to make the repayment of the original $10,000.***
>
> ***The original $10,000 loan is treated as a deemed dividend subject to the distributable surplus of the private company.***

Adding back payments for Division 7A purposes

6. Streaming

6.1 The paper will no consider the importance of, and ability to, stream as it stood before the Streaming Amendments. Then it will consider the Streaming Amendments.

Pre-Streaming Amendments

6.2 As can be seen from the illustrations above the ability to stream income according to its character is very important. This is particularly the case for franked dividends and capital gains but there are other forms of income with tax characteristics that may also be important e.g. income from a foreign source, income which has been subject to TFN withholding tax.

6.3 The decisions in Bamford tell us nothing about streaming income for tax purposes.

6.4 Most modern trust deeds will give the trustee power to distinguish between classes of income and to characterise a particular amount of income as having been derived from a particular source. The Deed should also allow the trustee to allocate expenses to the different classes of income.

6.5 The law regarding streaming after the decision in *CPT Custodian Pty Ltd v Commissioner of State Revenue [2005] HCA 53* ("**CPT Custodian**") was quite uncertain. The decision of the High Court in *Charles v C of T [1954] HCA 16* ("**Charles**") has always been the centre of gravity of the character flow through approach. The decision in Charles was heavily criticised by the Court in CPT Custodian. The question is whether that criticism went to the maintenance of character or is restricted to the characterisation of the interest in the trust fund by looking through to the underlying assets.

6.6 The decision of the High Court in CPT Custodian, in the writers' views, stands for the proposition that a beneficiary has an equitable interest in the residue of the trust fund after the Trustee's indemnity has been satisfied. This residue is characterless, whether it be income or capital, as the trustee may at any time satisfy its right to be indemnified from the receipts (which themselves have character).

6.7 Notwithstanding these problems the ATO has consistently taken the view that the character of the income in the hands of the beneficiary is taken from the character of the receipts of the Trustee[4] even after taking into account the decision in *CPT Custodian*[5].

6.8 In the non-binding ruling IT2328 (now withdrawn) it was observed:

> *"For income tax purposes where a beneficiary in a trust estate is presently entitled to the net income or a share of the net income of the trust estate, that income as a general principle has the same character in the hands of the beneficiary as it had in the hands of the trustee."*

6.9 The most significant streaming issues concern capital gains and dividends. In the case of capital gains Division 115 of Part 3-1 of the 1997 Act proceeds on an implication that income entitlements will take on at least some part of the character of the capital gains derived by the trustee. There is no clear legislative follow through. The guidance found in Sesction 115-200 of the 1997 Act establishes the implied maintenance of character:

> *"This Subdivision sets out rules for dealing with the net income of a trust that has a net capital gain. The rules treat parts of the net income attributable to the trust's net capital gain as capital gains made by the beneficiary entitled to those parts."*

[4] see in particular ATO ID 2008/51 dealing with Division 13.3A of the SIS Regulations.

[5] see Taxation Ruling STR 92/13, IT2328, IT2512, IT2004 (withdrawn) and ATO ID 2007/108 (which is concerned with foreign sourced income and in respect of which subsection 6B(2A) of the 1936 Act also comes into consideration).

6.10 Subsection 115-215(1) is the nub of the provisions:

> *"The purpose of this section is to ensure that appropriate amounts of the trust estate's net income attributable to the trust estate's capital gains are treated as a beneficiary's capital gains when assessing the beneficiary, so:*
>
> *(a) the beneficiary can apply capital losses against gains; and*
>
> *(b) the beneficiary can apply the appropriate discount percentage (if any) to gains."*

6.11 The process is described as attribution rather than maintenance of source character. This may be the necessary distinction to make the rules work. There is, however, no guidance about how the attribution is to be carried out.

6.12 What is clear is that if there is no trust income to which the beneficiary is presently entitled there can be no attribution. This is a major issue where there is no trading income but there are capital gains in the Trust. Use of s 95(1) terms to describe income overcomes this problem and makes the case for attribution much clearer. The capital gain (or at least 50% of it) will be included in the income. The connection for Subdivision 115-C purposes is very clear.

6.13 The ATO has had to resort to the artificiality of the "capital beneficiary approach" in PS LA 2005/1 (GA) to achieve this sensible outcome – but this practice statement was withdrawn following Bamford.

6.14 The issues with streaming can be readily appreciated in the context of capital gains and the 50% general CGT discount. The streaming issue is, of course, the denial of the 50% CGT general discount when a trust to company distribution is in play.

6.15 Maintaining the example used above in which there is a net capital gain of $100,000, and gross rental income of $50,0000 and net rental income of $20,000.

6.16 In this instance the trustee wishes to cause the capital gain to be assessed in the hands of an individual (say Mrs A) and the net rental income in the hands of a company, A Co. If it is assumed that the Trust Deed has all of the usual income characterisation and streaming provisions and the Deed adopts subsection 95(1) terms, the outcome readily appears.

6.17 The income entitlements are:

	$	
A Co	20,000	comprising net rental income
Mrs A	50,000	comprising the capital gain
	70,000	

6.18 If the ATO took the view that streaming was unobtainable the outcome would be:

	$	$ Total
A Co	5,714 + taxable capital gain $28,572	34,286
Mrs A	50,000	50,000
		84,286

6.19 The other area of concern is franking credits. At least there is a ruling on this aspect of streaming, *Taxation Ruling* 92/13 (repealed as of 22 June 2011 because of the Streaming Amendments). The provisions of Subdivision 207-B and in particular ss 207-45 to 207-57 are consistent with flow through of the franked character of a dividend.

6.20 The fact the Example set out immediately below s 207-35(3) of the 1997 Act depends on character maintenance. It is worthwhile setting this Example out in full:

> *"A franked distribution of $70 is made to the trustee of a trust in an income year. The trust also has $100 of assessable income from other sources. Under subsection (1) the trust's assessable income includes an additional amount of $30 (which is the franking credit on the distribution). The trust has a net income of $200 for that income year.*
>
> *There are 2 beneficiaries of the trust, P and Q, who are presently entitled to the trust's income. Under the trust deed, P is entitled to all of the franked distribution and Q is entitled to all other income.*
>
> *The distribution flows indirectly to P (as P is entitled to a share of that net income and has a 100% share of the distribution under section 207-55). P therefore has an amount of assessable income that is equal to its share of the distribution. Under this subsection, P's assessable income also includes the full amount of the franking credit (as P's share of the franking credit on the distribution is $30 under section 207-57). Q's share of the net income therefore does not include any of the franking credit."*

6.21 Clearly the legislation contemplates maintenance of character for the purposes of dividend imputation.

Commissioner's Concern of Division 6 Abuses

6.22 As usual the ATO is driven by the possibility that the decision in Bamford might support some abuse and revenue loss. No matter that their interpretations lead to massive headaches for practitioners.

6.23 This much is exampled by several examples set out *in Practice Statement PS LA 2009/7* which was released prior to the decision in Bamford.

6.24 Examples 1 and 5 in particular show what the ATO is on about.

6.25 Example 1 concerns the trustee of a family trust deriving $250,000 in income during the income year and applying that income to the purchase of a holiday home. The trustee, acting in accordance with a power expressed in the terms of the Trust Deed to do so, determines that the expenditure on the purchase of the house is an outgoing on income account with the effect that the trust law income available for distribution is $5,000. One of the beneficiaries has tax losses.

6.26 The trustee distributes the $5,000 trust law income to the loss beneficiary. The losses cover the tax law income which follows the trust law income to the loss beneficiary.

6.27 The ATO expresses concern about the mismatch of the actual amount to which the beneficiary becomes entitled ($5,000) and the amount of the tax law income flowing to the beneficiary ($250,000) and the tax not paid because of the losses.

6.28 It is difficult to say why this is of concern to them. The true effect of the transaction is to maintain $245,000 in the capital of the trust. The same tax effect would be obtained by distributing all of the $250,000 to the loss beneficiary. There is no tax difference in this illustration. It is unlikely there would be a tax benefit for the purposes of Part IVA. The most likely explanation for the transaction is the financial risk the loss beneficiary has been exposed to. If the beneficiary became entitled to call on the trustee to pay him or her $250,000 the creditors may be able to stake a claim to that amount. It is a neat and sensible piece of asset protection planning.

6.29 Example 5 is about a trust which has distinct income and capital beneficiaries. The trustee has a power to determine whether receipts and outgoings are on income or capital account. The Trust Deed is amended to admit a tax exempt entity as a beneficiary.

6.30 The trust derives $100,000 of income (meaning income according to ordinary concepts) during the income year. The trustee determines that $95,000 of that amount is a capital receipt. The remaining $5,000 is the trust law income according to the Trust Deed. This amount is appointed to the tax exempt beneficiary. All of the tax law income will be assessed to the charity. It would follow that the trustee makes a capital distribution of the $95,000 to a family beneficiary.

6.31 The ATO observe in the Practice Statement that Part IVA might apply in the circumstances. In the writer's view it almost certainly would do so in particular because of the amendment to introduce the tax exempt charity as a beneficiary and the fact that prior year distributions had been made only to family members. A much more challenging (and perhaps more realistic) illustration would arise if the tax exempt charity was already an object and the trustee had made distributions to charities in the past. The Part IVA case in such circumstances would be difficult to make out. This is an example of the acknowledged "apparent unfairness in the resulting administration of the legislation" as noted by the High Court in Bamford at [17].

6.32 The ATO apparently accept that Bamford authorizes characterization of capital receipts as income for the purposes of the Deed but are not so ready to accept that ordinary income may be recharacterised as capital (as in Example 5). They appear to be fortified in this by observations made by the Full Court of the Federal Court in *Forrest v C of T* [2010] FCAFC 6 ("**Forrest**").

6.33 The relevant question before the Court there was whether Mr Forrest was entitled to a deduction for interest he had incurred in relation to funds he had borrowed to acquire units in a unit trust. The outcome turned on whether there was a fixed income component to which the funds related. The Full Court concluded that a power to determine whether any amount received by the trustee was on revenue account or capital account (clause 12 of the Deed) was not a power to change the beneficiaries' rights. In so doing they observed at [11]-[12]:

> *'In our opinion, the power conferred by cl. 12 cannot be exercised by the trustee wrongly to classify a receipt as a capital gain, when the receipt is, in truth, income, and thus deprive the appellant of his interest in the unit component of the trust. Clause 12 is not an unlimited power to be exercised in the trustee's unconfined discretion….*
>
> *Clause 12.2(a) is a power to determine how a distribution to beneficiaries is classified. That limited power is not a power which is capable of altering the beneficiaries' rights. Clause 12 is to be read consistently with the balance of the Trust Deed and an appreciation that it contains various powers of an administrative character. The words used can be given full force honestly to classify income or distributions according to law, as the appellant contended to this Court".*

6.34 It is very difficult to know how far this goes. The issue in Forrest was about whether or not the exercise of the power changed the rights as between classes of beneficiaries. Presumably the ATO would say that the exercise of the power in a case like that in Example 5 was not an "honest" classification of the receipt as capital. Hopefully the issue will not arise very often.

Point of Interest

6.35 A case of interest is *Greenhatch v FCT* [2011] AATA 479 that ostensibly concerned superannuation contributions where the answer to the superannuation question was determined by construing streaming through a trust. The case of is interest for two reasons.

6.36 First, the AAT went out of their way to note the Commissioner's interpretation of Bamford was wrong. At [49] and [50] they said:

> *Much, if not all, of the Commissioner's case turns on his rejection of any underlying conduit theory and his interpretation of the implications of the decision in Bamford.*

The Commissioner's contention that the conduit theory has no role to play is based on foundations with which we do not agree. Accordingly, those foundations do not support the conclusion he seeks to draw.

6.37 Secondly, in relation to Subdivision 207-B of the 1997 Act, being the franking credits provisions, the AAT observed at [63]:

> *Section 207-35 of the 1997 Act has an aspect that makes the conclusion [that] amounts passing through trusts to beneficiaries thereof carry the character and identity that they had in the hands of the trustee more compelling. That section includes an example that contemplates differential distributions in determining the taxation burdens that are imposed on the beneficiaries of the trust.*

6.38 Question: was it necessary to introduce the Streaming Amendments in light of the above comments? Given we have the Streaming Amendments it is of academic interest only.

Streaming Amendments

6.39 The *Tax Laws Amendment (2011 Measures No. 5) Act* 2011 (Cth) was introduced into parliament (as a Bill) on 2 June 2011, was passed unamended and assented to on 29 June 2011. They take effect from 1 July 2010. These dates show how close a call it was as the Streaming Amendments are critical for trustee decisions that were needed to be made on 30 June 2011 – one day after their royal assent.

6.40 Subject to a statement by the Commissioner – extending the time a trustee could make decisions to 31 August 2011, which has anyway passed, but the writers question the Commissioner's ability to alter what trust law[6] requires to be done on 30 June of any year – the Streaming Amendments apply to trustees resolving to deal with trust income and capital gains.

6.41 From the 2011 income year and thereafter taxable capital gains and franked distributions are dealt with under these rules.

6.42 The Streaming Amendments operate by diverting from Division 6 of the 1936 Act the franked distributions and taxable capital gains. They are assessed directly in the hands of the beneficiaries who are presently entitled to them. They do this via Subdivision 207-B of the 1997 Act for franked distributions and via Subdivision 115-C of the 1997 Act for taxable capital gains. However, for the taxable capital gains they must still pass through the method statement in s 102-5(1) of the 1997 Act.

[6] *Trustees of the Estate Mortgage Fighting Fund Trust v FCT* [2000] FCA 981 per Hill J; *Case R105,* 84 ATC 692; *Antonopoulos v FCT* [2011] AATA 431.

6.43 The Streaming Amendments have introduced a new Division 6E into Part III of the 1936 Act to prevent double taxation. It adjusts the Division 6 income and net income of the trust to take out the amounts to which the beneficiary has been made specifically entitled.

6.44 It can be seen that the specific entitlement of the beneficiary or beneficiaries is the critical aspect of the Streaming Amendments. This is required to determine tax liability.

Specific Entitlement

6.45 The notion of a specific entitlement conceals the difficulties of applying the Streaming Amendments to all trusts, be they discretionary, fixed, unit, et cetera. The mechanism by which you become specifically entitled are set out in the relevant Subdivisions: s 115-228 for capital gains and s 207-58 for franked distributions. The provisions seem substantially similar at first look but there are some significant differences.

6.46 A beneficiary is specifically entitled under s 207-58 of the 1997 Act to an amount of a franked distribution made by the trust equal to the amount calculated under the following formula

$$\text{Franked Distribution} \times \frac{\text{Share of net financial benefit}}{\text{Net financial benefit}}$$

6.47 The "net financial benefit" is an amount equal to the financial benefit referable to the franked distribution (after an application by the trustee of expenses that are directly relevant to the franked distribution).

6.48 The term "financial benefit" is already in s 995-1 f the 1997 Act. It means anything of economic value, even if the transaction also imposes an obligation on the entity. Benefits and obligations are to be looked at separately and not set off against each other, but it is the net financial benefit to which the formula looks.

6.49 The "share of the financial benefit" is the amount of the financial benefit referable to the franked distribution specifically linked to the particular beneficiary. The share of the net financial benefit is:

> *… an amount equal to the *financial benefit that, in accordance with the terms of the trust:*
>
> *a. the beneficiary has received, or can be reasonably expected to receive, and*
>
> *b. is referable to the *franked distribution (after application by the trustee of any expenses that are directly relevant to the franked distribution) and*
>
> *c. is recorded, in its character as referable to the franked distribution, in the accounts or records of the trust no later than the end of the income year.*

6.50 Section 115-228 is identical to the discussion above of franked distributions, subject to:

6.50.1 the financial benefit must be referable to the capital gain "after application by the trustee of any losses, to the extent that the application is consistent with the application of capital losses against the capital gain in accordance with the method statement in subsection 102-5(1)"; and

6.50.2 the recording of the financial benefit must be "no later than 2 months after the end of the income year."

Complexities and Going Forward

6.51 An issue to be mindful of is – in fact an issue of significant importance – is that a trust with no "income", which was one of the problems in the Bamford appeals, will not be able to stream franking credits. This will mean that where the franked distributions, together with other ordinary income, is insufficient to more than offset expenses of the trust the franking credits cannot go through to the beneficiaries. The same restriction does not apply in relation to capital gains streamed through the trust.

6.52 Ken Schurgott FTIA, in his paper in the August 2011 *Taxation in Australia* titled "Trust streaming 2011" notes a number of complications that arise from the Streaming Amendments:

> *As will be seen, there are a number of issues which emerge that complicate the legislation over and beyond the rather simple approach adopted prior to the Commissioner's stance on streaming. The things which complicate matters are:*
>
> *a. There can be different outcomes according to the definition of income adopted by the trust deed;*
>
> *b. Significantly different outcomes can result where a beneficiary has not been made specifically entitled to the franked distribution or capital gain. This is most pronounced in relation to capital gains;*
>
> *c. The concept of making a beneficiary entitled to the entire financial benefit from a capital gain or franked distribution is fraught with difficulty, particularly where there are capital losses or directly related expenses; and*
>
> *d. The way in which capital losses and directly related expenses are to be dealt with is confusing.*

6.53 It can be seen from these further issues, and the problem of actually apply what is a simple concept of diverting the amounts to Subdivisions 115-C and 207-B respectively, are anything but straightforward or settled. Indeed, a senior council on the writer's floor, after having advised on

the Streaming Amendments is of the view that this is where future archeologists will find the bones of 21st Century tax lawyers and accountants.

7. Changes to the taxation of trusts – terms to be provided for in a trust document

7.1 Given the changes in the taxation of trusts, it is recommended that trust deed (or any other constituent documents) be reviewed so as to determine:

7.1.1 How income, capital gains and outgoings are accounted for and determined; and

7.1.2 How income, capital gains and outgoings are to be distributed.

7.2 Some of the powers which may be advantageous to have within a trust instrument include:

7.2.1 an accounting policy which is sufficiently broad and allows the trustee to exercise maximum discretion;

7.2.2 the discretion to reclassify and allocate income and capital gains;

7.2.3 the discretion to reclassify and allocate outgoings;

7.2.4 the discretion not to recoup losses (whether income or capital in nature);

7.2.5 the ability to allocate and stream classes of income and capital and their related tax attributes;

7.2.6 and ensure that any unpaid present entitlement / loan provisions are removed, and an ability to hold amounts subject to a sub-trust.

7.3 Some additional powers to be considered include:

7.3.1 whether the trustee has the power to distribute income and / or capital at any time within a tax year;

7.3.2 whether any determination of income (or capital) can be made within the income tax year; and

7.3.3 whether the trustee has a power to determine entitlements with respect to an income tax year after the relevant year.

Accounting policy

7.4 Essential is ensuring that the trust deed provides guidance with respect to an accounting policy that should be used by the trustee. Such an accounting policy should provide sufficient flexibility for the trustee, so that it may depart from generally accepted accounting standards in the event that the trustee considers that it is appropriate to do so.

Reclassifying and allocating income and capital

7.5 As the High Court in *Bamford* accepted that the tax law income of a trust is dependent upon (amongst other things) the definition of that term in the trust deed, regard should be given to the definition of the 'income' as contained in the trusts constituent documents.

7.6 An issue to consider is whether attributed amounts (e.g. franking credits) should be included within the definition of trust income. An issue that arises is that if attributions are included in trust income (and which are not physically 'paid' by a trustee – but which follow certain amounts of income), whether by being included in trust income, and thereby providing that a trustee creates a 'present entitlement' in a beneficiary to an amount that is never received by a trustee, the trustee will be exposed to a claim in relation to amounts that are not actually received by the trustee.

7.7 It is submitted that amounts such as franking credits should be prima facie carved-out of the definition of income. However, the definition should contain discretionary elements to allow a trustee to cause such 'attributed' amounts to fall within the definition of income.

7.8 An approach which may be considered is, in defining trust income:

7.8.1 Provide that it prima facie equals the amount provided for in s 95(1) of the 1936 Act (less any franking credits);

7.8.2 If the tax law approach is not warranted for a particular tax period, then:

7.8.2.1 According to an accounting policy adopted by the trustee; or

7.8.2.2 Any other basis as determined by the trustee; or

7.8.3 In the trustee's absolute discretion, the gross income of the trust.

Reclassifying and allocating outgoings

7.9 In *Cajkusic v FC of T (No 2)* (2006) ATC 4752 ("**Cajkusic**") deductions allowable to a family discretionary trust for payments that were made under an employee benefits trust arrangement in the income tax years ending 30 June 1997 and 30 June 2008 caused there to be a loss within the trust estate.

7.10 As a result of the losses, there was no distributable income of the trust. As a result, the Full Court of the Federal Court held that the lack of distributable income meant that there could be no beneficiary of the trust (for the relevant income tax years) to be "*… presently entitled …*'"pursuant to s 97 of the 1936 Act to any amount.

7.11 It should be noted that the Commissioner's subsequent application for special leave to appeal to the High Court was rejected.

7.12 Cajkusic stands for the proposition that the 'distributable income' of a trust is determined by reference to proper accounting principles, as well as the terms of a trust deed. In this context distributable income is income determined according to accounting principles, and which is distributable amongst the beneficiaries. It does not alter either the income as calculated under accounting principles, of the 'net income' as determined under s 95(1) of the 1936 Act – rather, only gives a trustee the power to determine the distributable amounts.

7.13 As a result of the decision in Cajkusic, it is submitted that a trust deed should give a trustee the power to reclassify, and allocate outgoings, so that there can be 'distributable income' to which beneficiaries are presently entitled.

Discretion not to recoup losses (whether income or capital in nature)

7.14 It is recommended that a trustee have a discretion not to recoup losses (whether of an income or capital nature). That is, a power not to recoup losses which have arisen in the past.

8. Resettlement considerations

8.1 Whenever the terms of a trust are varied, an issue to consider is whether the variation amounts to a 'resettlement'.

8.2 Resettlements relate to changes to a trust relationship which have the effect that a new trust estate comes into existence. According to the High Court in *FC of T v Commercial Nominees of Australia Ltd* [2001] HCA 33 (***"*Commercial Nominees"**), the issue to determine is whether '*… what occurred* … [i.e. the variation] … *was a fundamental alteration in the trust relationship*

established by the original deed, such that it destroyed the necessary continuity of the 'taxpayer'…'.

8.3 A resettlement can have significant income tax, capital gains tax (**'CGT'**) and stamp duty consequences, including that:

8.3.1 the trust property may be disposed of, potentially triggering both stamp duty and CGT liabilities;

8.3.2 carried forward tax benefits may be lost; and

8.3.3 beneficiaries may dispose of their interests in the original trust and acquire interest in a new trust.

8.4 Specifically in the context of CGT, a resettlement may cause either CGT event E1 (s 104-60 of the 1997 Act) or CGT event E2 (s 104-65 of the 1997 Act) to happen.

8.5 In August 2001 the issued a Statement of Principles entitled *Creation of a new trust* (the **"Statement**"). The Statement clarifies when, in the Commissioner's view, changes to a trust gives rise to a new trust. The Commissioner considers that a new trust estate arises where there is a 'fundamental change to a trust relationship' – ie, a change in the essential nature and character of the original trust relationship. Further, the Commissioner considers that a new trust (i.e. a resettlement) may arise in the following circumstances:

- a change in beneficial interest in trust property;
- a new class of beneficial interest (whether introduced or altered);
- a redefinition of the beneficiary class;
- changes in the terms of the trust or the rights or obligations of the trustee;
- changes in the nature of the trust property;
- additions of property which could amount to a new and separate settlement;
- depletion of trust property;
- a change in the termination date of the trust;
- a change in the trust that is not contemplated by the terms of the original trust;

- a change in the essential nature and purpose of the trust; and / or
- a merger of two or more trusts or a splitting of the trust.

8.6 The Commissioner considers that depending on their nature and extent, the above changes may either amount to:

8.6.1 a variation of a continuing trust; or

8.6.2 a fundamental change in the essential nature and character of the trust relationship. In such a case, the original trust may be brought to an end and a new trust created. Whether a new trust is created depends on the terms of the original trust and on the powers of the trustee.

8.7 The High Court in Commercial Nominees held that significant changes to a superannuation fund trust deed did not create a new trust, even though the amending deed had:

8.7.1 changed the name of, and appointed a new trustee to the fund;

8.7.2 introduced a new category of beneficiaries;

8.7.3 changed the fund from a defined benefit fund to an accumulation fund;

8.7.4 appointed a professional management company as administrator; and

8.7.5 allowed membership to be promoted to the public.

8.8 The High Court in *Commercial Nominees* considered that there were three main indicators of the continuity of a trust relationship, being:

8.8.1 the constitution of the trust;

8.8.2 the trust property; and

8.8.3 the membership of the trust.

8.9 Substantial changes any of the above may cause a resettlement.

8.10 The High Court considered that, in order to destroy the necessary continuity, changes in one or more of the above indicators must be such as to terminate the existence of the entity, or to produce the result that the particular trust does not derive the income in question. It was held that the changes made to the trust deed in question were not sufficient to destroy the continuity, primarily because the fund was at all times governed by the same deed, the trust property did not change, and the members before the amendment to the trust deed remained members afterwards. We consider that the amendments discussed above will not cause a resettlement.

8.11 The Commissioner notes in the Statement that administrative changes, such as re-defining trust income (without more) may not cause a resettlement (depending on the context) as it may be administrative in nature.

8.12 However, regard will need to be given to the implications to the membership (i.e. the beneficial entitlements) of the trust, and what implications such an amendment will have on the respective entitlements in a trust. For example, an important consideration will be determining how unallocated / undistributed income is to be dealt with. For example, is such income:

8.12.1 accumulated, and form part of the corpus of the relevant trust estate;

8.12.2 is it distributed to certain default beneficiaries; or

8.12.3 is it held on trust for a specific purpose (e.g. a charitable purpose).

Changes in the Taxation of Trusts

A paper presented by Michael Bennett and Denis Barlin at the NSW Young Lawyers CLE

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Michael Bennett E bennett@sevenwentworth.com.au D 8224 3055 M 0408 029 416
Denis Barlin E dbarlin@wenworthchambers.com.au D 9231 6646 M 0404 848 311

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1. General overview

1.1 The income years ended 30 June 2010 and, more particularly, 30 June 2011 have been very active for the taxation of trusts. Significant events in three areas of trust taxplay activity:

1.1.1 decisions of the Courts and principally the High Court's decision in *Commissioner of Taxation v Bamford* (2010) 240 CLR 481; (2010) 264 ALR 436; [2010] HCA 10 ("**Bamford**");

1.1.2 legislative changes, principally:

1.1.2.1 the new rules set out in *Tax Laws Amendment (2011 Measures No. 5) Act* 2011 (Cth) (the "**Streaming Amendments**") that deal with taxation of franking credits and capital gains in trusts; and

1.1.2.2 the new rules set out in the *Tax Laws Amendment (2010 Measures No. 2) Act* 2010 (Cth) that are principally about Division 7A of Part III of the *Income Tax Assessment Act* 1936 (Cth) (the "**1936 Act**") and companies providing rights to use property, but also contain some trust issues (the "**Div 7A Amendments**"); and

1.1.3 Australian Taxation Office ("**ATO**") activities principally the very controversial draft ruling on unpaid present entitlements, TR 2009/D8.

1.2 Some of these changes have overtaken themselves. For instance, there was at the time – and this paper includes – a discussion of streaming post Bamford (see **heading 4** below). That discussion should be read as having been overtaken by the Streaming Amendments (see **heading 5**).

1.3 And what's more the change is not over. Chapter 2 of the explanatory memorandum to the Bill that introduced the Steaming Amendments makes it clear that the streaming provisions have been introduced as an interim measure to deal with perceived anomalies in the taxation of capital gains and franked distributions pending a comprehensive review of Division 6 of Part II of the 1936 Act.

1.4 The changes made so far give rise to issues themselves and further consequential issues for trusts. In addressing the issues – both outlined above and the consequential issues – this paper will discuss:

1.4.1 Taxation of trusts generally;

1.4.2 The competing views before Bamford;

1.4.3 The context of Bamford and what it means for trusts;

1.4.4 Briefly (as it is not germane to the other issues raised in the paper) what are the Div 7A Amendments and what they mean for trusts;

1.4.5 What are the Steaming Amendments and what they mean for trust;

1.4.6 What a trust deed needs in light of those three issues; and

1.4.7 Amending trust deeds to deal with those three issues.

1.5 The issues are dealt with in this order as they are chronological to their occurring.

2. Taxation of Trusts

2.1 The provisions dealing with the taxation of trust income are contained in Division 6 of Part III of the 1936 Act (which comprises of sections 95 to 102).

2.2 As a result of the enactment of Streaming Amendments, regard should also be given to:

2.2.1 Subdivision 207-B of the *Income Tax Assessment Act* 1997 (Cth) (the "**1997 Act**") – which deals with franking credits obtained by a trust estate; and

2.2.2 Subdivision 115-C of the 1997 Act – which deals with the distribution of capital gains by a trust estate.

2.3 Chief Justice Latham in *Tindal v FC of T* (1946) 72 CLR 608 at 618 observed that the object of Division 6 of the 1936 Act is to "*… secure payment of tax upon the whole of the net income of a trust estate, either from a beneficiary or the trustee, whether the income is paid over to or on account of the beneficiary …*". Further, according to Emmett J in *Bamford v Federal Commissioner of Taxation* (2009) 176 FCR 250 "*… an important assumption underlying Division 6 …* [is] *… that a beneficiary who derives a share of the net income should be in a position to pay out of that income; otherwise, the beneficiary could be placed in a difficult position*."

2.4 The starting point in determining the taxation of trust income is s 97 of the 1936 Act. Relevantly, s 97(1) of the 1936 Act 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; and

(b) the exempt income of the beneficiary shall include:

(i) so much of the individual interest of the beneficiary in the exempt income of the trust estate as is attributable to a period when the beneficiary was a resident; and

(ii) so much of the individual interest of the beneficiary in the exempt 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;

except to the extent to which the exempt income to which that individual interest relates was taken into account in calculating the net income of the trust estate; and

(c) the non-assessable non-exempt income of the beneficiary shall include:

(i) so much of the individual interest of the beneficiary in the non-assessable non-exempt income of the trust estate as is attributable to a period when the beneficiary was a resident; and

(ii) so much of the individual interest of the beneficiary in the non-assessable non-exempt 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]

2.5 That is, s 97 of the 1936 Act provides that where a beneficiary, who is not under a legal disability is presently entitled to a "*… share of the income of the trust estate …*", the assessable income of:

2.5.1 a resident beneficiary includes the beneficiary's share of the '*… net income of the trust estate …*'; and

2.5.2 a non-resident beneficiary includes so much of the beneficiary's share of the net income of the trust as is attributable to sources in Australia.

2.6 It should be noted that the term "net income of the trust estate" for the purposes of s 97 of the 1936 Act is defined in s 95(1) of the 1936 Act. However, the term "*… the income of the trust estate …*" as contained in s 97 of the 1936 Act is not defined in the 1936 Act.

2.7 Subsection 95(1) of the 1936 Act defines the term 'net income', in relation to a trust estate as:

> ***net income**, 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 Division 393 of the Income Tax Assessment Act 1997 (Farm management deposits) 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.*

2.8 For completeness, it should be noted that:

2.8.1 s 98 of the 1936 Act provides that the trustee is liable to tax on behalf of a beneficiary where the beneficiary is presently entitled to a share of the income of a trust estate, but the beneficiary is under a legal disability;

2.8.2 ss 99 and 99A of the 1936 Act apply to subject the trustee to tax where there is some part of the net income of a trust estate that is not subject to tax under either of ss 97 or 98 of the 1936 Act. The difference as between s 99 and s 99A of the 1936 Act is the rate of tax applicable. Typically, the trustee will be subject to tax under section 99A of the 1936 Act at a penal rate of tax equal to the maximum rate of tax (currently 45%). However, the Commissioner has a discretion to apply s 99 of the 1936 Act in certain circumstances, in which case the trustee will be subject to tax at the normal marginal rates of tax.

3. The two competing views before the decision in Bamford

3.1 There has been, for some time, two competing views in the taxation of trust income – the proportionate view and the quantum view.

Proportionate approach

3.2 *David & Anor v FC of T* 89 ATC 4377 contains an example of the application of the proportionate approach (which according to the High Court's decision in Bamford, is the correct approach).

3.3 The proportionate view looks to the share (or proportion) of trust law income of a trust to which a beneficiary is "presently entitled", and then applies that share or proportion to the net income of a trust estate to calculate how much of the net income is to be included in the beneficiary's assessable income.

3.4 As an example, if a beneficiary is entitled to one half of the trust law income, then the beneficiary must include half of the net income in their assessable income – irrespective of whether it is more or less than the amount of the trust law income to which they are entitled.

(a) Implications if tax law income exceeds trust law income

3.5 Under this approach, a beneficiary who is "presently entitled" to trust law income may be required under s 97(1) of the 1936 Act to include in their assessable income an amount of net income which is greater than the amount of trust law income to which they are entitled, and to which has been paid or distributed to them.

3.6 That is, they may be subject to tax on amounts whish they will not receive, and are not entitled to actually receive.

3.7 This outcome seems to be contrary to the objectives of Division 6 of the 1936 Act as outlined by Emmett J in the Full Court of the Federal Court decision in *Bamford v Federal Commissioner of Taxation* (2009) 176 FCR 250 (discussed above).

(b) Implications if trust law income exceeds tax law income

3.8 However, where the net income of a trust estate for the purposes of s 95(1) of the 1936 Act is less than the trust law income, then a beneficiary who is "presently entitled" pursuant to s 97(1) of the 1936 Act will be required to include in their assessable income an amount which is less than the trust law income to which they will be entitled, and which will be paid to them.

3.9 As a result, an on the assumption that the beneficiaries are "presently entitled" to the whole of the trust law income, with the result that the whole of the "net income" of the

trust estate is included in their assessable income pursuant to s 97(1) of the 1936 Act, there can be no part of the net income to which ss 99 or 99A of the 1936 Act applies.

3.10 There is still a question as to whether, in these circumstances, the beneficiary must include the excess amount (i.e. the amount not included under s 97(1) of the 1936 Act) under some provision of the tax acts (e.g. CGT event E4 as contained in s 104-70 of the 1997 Act).

The quantum approach

3.11 The quantum approach (which is no longer good law) is based on the proposition that a beneficiary can only be presently entitled to such amount(s) of trust income as they actually receive.

3.12 Further, any part of the net income of the trust estate which exceeds the amount to which the beneficiary is presently entitled is not income to which the beneficiary is presently entitled to pursuant to s 97 of the 1936 Act, with the result that the trustee is subject to tax on it under s 99A of the 1936 Act (unless the Commissioner exercises it discretion to cause it to be subject to tax under s 99).

3.13 As with the proportionate approach, where the net income of the trust estate for s 95(1) of the 1936 Act purposes is less than the trust law income, such that the beneficiary receives an amount which is greater than the amount included in their assessable income, the question arises as to how the excess is to be taxed (if at all).

4. Bamford

4.1 Bamford was a much anticipated decision. In the view of some[1] the decision was a missed opportunity to settle an area of the trust law and tax law that has been crying out for correction: *Bamford* at [17] citing Hill J in *Davis v Federal Commissioner of Taxation* (1989) 86 ALR 195 at 230.

Background to Bamford

4.2 Mr and Mrs Bamford were beneficiaries of a discretionary trust known as the Bamford Trust (the "**Trust**"). The trustee of the Trust was P&D Bamford Enterprises Pty Ltd. Mr and Mrs Bamford were also the directors and employees of P&D Bamford Enterprises Pty Ltd.

[1] Slater QC *Taxation Trust Income After* Bamfor'ds *Case*, 26th National TIA Convention, 2-4 March 2011

4.3 During the 2000 income tax year, the Trust made a contribution to an offshore superannuation fund on behalf of Mr and Mrs Bamford. The contribution was sourced from borrowings by the corporate trustee, in its capacity as trustee of the Trust.

4.4 For the purposes of determining the "net income" of the Trust for the 2000 income tax year, the corporate trustee (in its capacity as trustee of the Trust) claimed a deduction for both the contribution made to the offshore superannuation fund, and the interest on the borrowed funds used to make the contribution. The total deduction claimed was $191,701.

4.5 After taking into account of the deductions, the "net income" of the Trust for that year was distributed to specified beneficiaries of the Trust. Included in the distribution were Mr and Mrs Bamford, who both had specified amounts distributed to them.

4.6 Specifically, for that income tax year (i.e. the 2000 income tax year), the trustee of the Trust allocated amounts to certain beneficiaries of the Trust, including a payment of $34,000 each to Mr and Mrs Bamford. However, the trustee of the Trust did not have sufficient funds to pay the full amount of $34,000, and instead paid them $33,872, being what the trustee of the Trust thought was the total remaining trust funds.

4.7 The amount initially distributed by the trustee of the Trust was $187,530.

4.8 In 2005, the Commissioner of Taxation applied the anti-avoidance provisions so as to disallow the deductions of the Trust (for the 2000 income tax year) for the superannuation contribution and the interest. As a result of the denial of the deductions, for the purposes of the 2000 income tax year the Trust's taxable income exceeded its accounting income.

4.9 The decision essentially dealt with two things:

4.9.1 whether the 'proportionate approach' applied in the event that tax law income exceeds accounting / trust income; and

4.9.2 whether the trust deed of the trust could characterise an amount of capital gains as income of the Trust.

Application of the proportionate view

4.10 As a result of the denial of the deduction, the Trust's taxable income increased by $191,000. The Commissioner issued amended income tax assessments to both Mr and Mrs Bamford. Pursuant to the assessments, the Commissioner contended that Mr and Mrs Bamford were liable to tax on the increased 'net income' of the Trust based on the proportionate share of the amount by which the taxable income of the trust exceeded the accounting income.

4.11 Indeed, the Commissioner sought to assess Mr and Mrs Bamford on an extra $34,624, on the basis that that amount represented the 'share' of the additional $191,000 as their share (i.e. 18%) of the previous amount (i.e. $187,530) actually distributed.

4.12 However, the taxpayers argued that they should only be taxed on the difference between the $33,872 which they actually received, and the specific amount of $34,000 which was originally allocated to them (i.e. an amount of $128 each).

4.13 The High Court rejected the taxpayer's argument, and in doing so applied the "proportionate approach".

4.14 The High Court took a two step approach in dealing with this issue:

4.14.1 First – the High Court held that the term "*… income of the trust estate …*" as contained in s 97(1) of the 1936 Act refers to distributable income, being income as determined by the trustee taking into account the terms of the trust (e.g. the trust deed) and appropriate accounting principles.

4.14.2 Secondly – after ascertaining the "share" of the distributable income to which a beneficiary is presently entitled, s 97(1) of the 1936 Act then requires that "*… that share of the net income of the trust estate …*" be ascertained, being the shares of the taxable income and not the distributable income.

4.15 Further, it was held that the inclusion within s 97(1) of the 1936 Act of the defined phrase "*… net income of the trust estate …*" and the undefined term "*… the income of …* [the] *… trust estate …*" indicated that these were intended to have different meanings. As a result, the term "*… the income of …* [the] *… trust estate* " had a different and defined meaning for taxation purposes.

4.16 The Court at [45] held that the analysis of Sundberg J in *Zeta Force Pty Ltd v Commissioner of Taxation* (1998) 84 FCR 70 at 74-75 should be applied:

> *The resolution of the second issue of construction is to be found in the analysis by Sundberg J in* Zeta Force Pty Ltd v Commissioner of Taxation *… . His Honour dealt with the first issue of construction to the same effect as that just explained, saying:*
>
> > *"The words 'income of the trust estate' in the opening part of s 97(1) refer to distributable income, that is to say income ascertained by the trustee according to appropriate accounting principles and the trust instrument. That the words have this meaning is confirmed by the use elsewhere in Div 6 of the contrasting expression 'net income of the trust estate'. The beneficiary's 'share' is his share of the distributable income."*
>
> *Sundberg J then continued:*
>
> > *"Having identified the share of the distributable income to which the beneficiary is presently entitled, s97(1) requires one to ascertain 'that share of the net income of the trust estate'. That share is included in the beneficiary's assessable income. The expression 'net income of the trust estate' in par (a)(i) has the meaning given it by s 95(1) – taxable income as opposed to distributable income. The words 'that share' in par (a)(i) refer*

back to the word 'share' in the expression 'a share of the income of the trust estate', and indicate that the same share is to be applied to an income amount calculated according to a different formula (taxable income as opposed to distributable income). Since the income amount may differ according to which formula is applied, the natural meaning to give to 'share' where it appears for the second time is 'proportion' rather than 'part' or 'portion'. When Parliament wanted to convey the latter meaning, as it did in ss 99 and 99A, it used the word 'part'.

The contrast between the expressions 'share of the income of the trust estate' and 'that share of the net income of the trust estate' shows that the draftsman has sought to relate the concept of present entitlement to distributable income, and not to taxable income, which is, after all, an artificial tax amount. Once the share of the distributable income to which the beneficiary is presently entitled is worked out, the notion of present entitlement has served its purpose, and the beneficiary is to be taxed on that share (or proportion) of the taxable income of the trust estate."

4.17 For the 2000 income year, the "net income" of the Trust included the amount of $191,701 which should not have been claimed as a deduction in the tax return of the Trust. As a result, the High Court held that the assessable income of Mr and Mrs Bamford should include a share of that amount, equivalent to the share they each received of the distributable income.

Whether the trust deed could re-characterise amounts

4.18 The trust deed of the Trust gave the trustee the discretion to determine whether a particular receipt should be treated as income or capital.

4.19 The trustee relied on this power to pass a resolution to distribute the first $60,000 of net income, "*… including …* [the] *…. capital gain …*" to Mr and Mrs Bamford in equal shares.

4.20 The Commissioner argued that the capital gain was not income of the Trust. Further, since there was no income, no beneficiary could be 'presently entitled' to the amount in question, the trustee of the Trust should be assessed at the special rates.

4.21 The High Court held that the term "income" as contained in s 99A of the 1936 Act should be interpreted as income of the trust estate, as understood in trust law.

4.22 As a result, the net capital gain of the Trust became the income of the Trust after the trustee exercised its discretion to characterise the capital gain as income of the Trust.

Outcome for Trust Distributions

4.23 There is no room for doubt that Bamford establishes that:

4.23.1 income of the trust estate identified in s 97(1) of 1936 Act is to be determined according to any directions set out in the Trust Deed;

4.23.2 the share of the net income attributable to a beneficiary is to be determined in the same proportions in which the beneficiary enjoys the present entitlement to the share of the income of the trust.

4.24 In this first regard, the Court made it clear that the general rules regarding apportionment between capital and income of receipts and outgoings was largely based on assumptions which could be displaced by the terms of the trust instrument: Bamford at [17]. The general law of trusts operates to give meaning to the term "the income of the trust estate".

4.25 The determination of present entitlement to a share of the income is a process of trust administration. The decision of the Full Court of the Federal Court in *C of T v Totledge Pty Ltd* (1982) 40 ALR 385 at 393 is quoted in support: Bamford at [39]. The High Court distinguished its own decision in *C of T v Australia and New Zealand Savings Bank Ltd* (1998) HCA 53 (Bamford at [39]) as not relevantly addressing the issue. Finally, the Court observed that the Commissioner's lack of consistency in wishing to exclude "statutory income" from "income of the trust estate" did not assist his argument that "income" means "income according to ordinary concepts": Bamford at [41].

4.26 On the meaning of the term "share of the net income" the High Court adopted the proportionate approach advocated by Sunberg J in *Zeta Force* (discussed above).

4.27 What does this translate into for trustees making decisions in respect of trust distributions for the 2010 income year?

4.28 There are a number of relevant observations to be made.

4.29 First, if the Trust Deed provides a formula for determining the income of the trust then that formula will determine the entitlement of the beneficiaries to income. If, for example, the Deed contains words to the following effect:

> *"The net income of the trust is an amount equal to the amount determined in accordance with subsection 95(1) of the* Income Tax Assessment Act 1936 *but reduced by any amount which would otherwise be included by application of Division 207 of the* Income Tax Assessment Act 1997*".*

4.30 Throughout this paper "subsection 95(1) terms" means an amount adjusted for the franking credit gross up. The issue of grossing up is considered below in the context of using the full tax exemption including the franking rebate available to children.

4.31 Leaving aside the elimination of any gross up for franking credits (which itself is affected by the Streaming Amendments as discussed below) the amount of net income for trust law purposes

will equal the tax law income. The two will coincide so that there should, in the ordinary course, be no amount assessable to the trustee under s 99A of the 1936 Act.

4.32 Secondly, if the Trust Deed is silent then "ordinary income" principles apply. Just what they are is difficult to say. The ATO has expressed the view that income of a trust is income according to ordinary principles. This is not the same thing as accounting income determined in accordance with accounting principles. It requires a dissection of receipts into:

4.32.1 income according to ordinary principles;

4.32.2 income which is not ordinary income;

4.32.3 capital receipts.

4.33 Following that dissection, the expenses must be apportioned accordingly.

4.34 This is, of course, all too much. Many trust deeds will have a clause like that in Bamford which allows the trustee to determine whether a receipt is capital or income. Others will have very broad powers allowing the trustee to determine the basis on which income of the trust is to be worked out.

4.35 If these powers exist they should be used to avoid uncertainty brought about by the "ordinary income" approach. If they do not exist then the deed should be to give the trustee such a power. Whether such an amendment will amount to a resettlement, which might have adverse capital gains tax (and stamp duty) consequences, is discussed at **paragraphs xx** below.

4.36 Thirdly, because the proportionate approach has prevailed, a strict application of that rule will mean that great care needs to be taken when seeking to direct a specific amount of tax law net income to a particular beneficiary with absolute certainty e.g. the maximum amount to a child which escapes the punitive rates under Division 6AA of the 1936 Act. This issue is illustrated in the Examples which follow.

4.37 Fourthly, the High Court decision says nothing about streaming of trust income. The matter was not in issue. The uncertainty about streaming of income according to its character remained unabated, until the Streaming Amendments.

4.38 Finally, the ATO has done away with the benevolent "capital beneficiary" approach set out in Practice Statement PSLA 2005/1 (GA) on and from 13 October 2010.

Examples

4.39 The best way to illustrate these points is by way of example. In the examples which follow the following facts apply in relation to the A Family Trust for the income year ended 30 June 2010:

Receipts:

rent	$50,000
net capital gain	$100,000

Expenses:

rental expenses	$10,000
interest	$20,000

4.40 The interest relates to the rental property only. The discountable capital gain was made on the sale of shares in a listed company. The intended beneficiaries are Mr and Mrs A and their two children both under 18.

4.41 Because of the low income rebate the following no-tax thresholds apply to minors:

Income Year end 30 June	**$**
2010	3,000
2011	3,333

4.42 If the income constitutes fully franked dividends the cash payment thresholds and grossed up taxable income amounts are:

Income Year end 30 June	**$ cash**	**$ taxable income**
2010	6,300	9,000
2011	7,000	10,000

4.43 These figures have considerable significance for trustees seeking to hit the no tax "sweet spot" for a distribution to a child.

(a) Subsection 95(1) terms apply – no "balance approach"

4.44 The taxable capital gain is $50,000. Accordingly, the distributable trust income is $70,000.

4.45 For 2010 a minor may be distributed $3,000 with no tax liability if entitled to the low income rebate (see comments above).

4.46 The trust distribution minutes might give effect to the following:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000

70,000

4.47 The tax law results will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.48 The cash in the trust will include the $50,000 covered by the 50% general CGT discount. This is not income and can be dealt with as capital. As this is a discretionary trust it can be distributed without tax consequences.

(b) Ordinary income applies – no "balance approach"

4.49 In this instance the trust distribution minutes will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	7,000
Mr A	7,000
	20,000

4.50 The tax law results will be:

	$
Child 1	$3{,}000 + {}^{3,000}/_{20,000} \times \$50{,}000$
Child 2	$3{,}000 + {}^{3,000}/_{20,000} \times \$50{,}000$
Mrs A	$7{,}000 + {}^{7,000}/_{20,000} \times \$50{,}000$
Mr A	$7{,}000 + {}^{7,000}/_{20,000} \times \$50{,}000$

4.51 The final results:

	$
Child 1	10,500
Child 2	10,500
Mrs A	24,500

Mr A	24,500
	70,000

4.52 This is a strict application of the proportionate approach.

4.53 Each of the children will pay tax on $7,500 at the Division 6AA punitive rates of 45%. This is not a good result.

(c) Subsection 95(1) applies – "balance approach" used

4.54 Trust minutes:

	$
Child 1	3,000
Child 2	3,000
Mrs A	half of the balance
Mr A	half of the balance

4.55 Trust income entitlements:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.56 The tax law result:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.57 This is the same outcome as where no "balance approach" is applied – but see below for the effect of a tax adjustment.

(d) Ordinary income applies – "balance approach" used

4.58 Trust minutes

	$
Child 1	3,000
Child 2	3,000
Mrs A	half of the balance
Mr A	half of the balance

4.59 Trust income created will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	7,000
Mr A	7,000
	20,000

4.60 The tax law results will be:

	$
Child 1	$3{,}000 + {}^{3,000}/_{20,000} \times \$50{,}000$
Child 2	$3{,}000 + {}^{3,000}/_{20,000} \times \$50{,}000$
Mrs A	$7{,}000 + {}^{7,000}/_{20,000} \times \$50{,}000$
Mr A	$7{,}000 + {}^{7,000}/_{20,000} \times \$50{,}000$

4.61 The final results:

	$
Child 1	10,500
Child 2	10,500
Mrs A	24,500
Mr A	24,500
	70,000

4.62 Again there is no difference. However, the "balance approach" is more realistic because it is unlikely that the trust income or tax law income will be known as at any 30 June. In reality these figures are not known until the accounts are drawn later in the calendar year.

(e) Tax Law Adjustments

4.63 It is often important to anticipate an adjustment to the trust's tax law income especially where there is something contentions going on.

4.64 As has been seen the tax law result will follow on a proportionate basis the entitlements to income created under the Deed. To test the outcome it is assumed in the above examples that the trustee failed to recognise $10,000 of rental income (say the trustee at first considered that the income was to be deferred until the 2011 income year) but was in fact wrong about this.

4.65 How do the various approaches deal with such an adjustment?

Example (a) – subsection 95(1) applies (but no "balance approach")

4.66 The trust law entitlements and tax law results were the same:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.67 The tax law adjustment will increase both the trust law entitlement and the tax law income by $10,000. The Trustee has not dealt with this $10,000 and, without an operative default beneficiary clause, it will be assessed to the Trustee under section 99A of the 1936 Act.

4.68 The trust law entitlements and tax law result will be:

	$
Child 1	3000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
Trustee	10,000
	80,000

4.69 However, if there is no streaming of the capital gain (with the effect that all beneficiaries are entitled to a proportionate part of the capital gain) that part of the capital gain reflected in the income to which no beneficiary is presently entitled will be grossed up for the loss of the 50% general CGT discount. Five eighths of the $10,000 adjustment assessed to the Trustee is capital gain. As a result the share of the net income assessable to the Trustee will be increased by $6,250.

4.70 The final result will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
Trustee	16,250
	86,250

4.71 This is a costly outcome.

Example (c) – subsection 95(1) but using a "balance approach".

4.72 The trust law entitlement and tax law result were the same.

	$
Child 1	3,000
Child 2	3,000
Mrs A	half of the balance
Mr A	half of the balance

4.73 The unadjusted result was:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.74 The adjusted trust law entitlement and tax law result will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000 + 5,000
Mr A	32,000 +5,000
	80,000

4.75 The "balance approach" together with adoption of s 95(1) terms directs all of the tax law result from an adjustment made by the ATO to the balance beneficiaries.

4.76 If the balance distribution has been used Mr and Mrs A will "enjoy" a further $5,000 of income entitlement (it now having been correctly determined) and a further $5,000 of tax law net income each. No amount will be assessed to the trustee.

4.77 There is an argument that the beneficiaries have not become presently entitled to the amount of the adjustment to the trust law net income as it was not ascertained at the end of the income year. In the writer's opinion the trust law net income was always the amount as correctly adjusted by the ATO. There was never any uncertainty about it. It is simply the case that the trustee and ATO had not properly determined the correct quantum of income.

4.78 In practical terms how have the Courts looked at the "balance approach"? It has not come up that often.

4.79 The decision of Cooper J in *BRK (Bris) Pty Ltd v C of T* [2001] FCA 164 might at first blush give cause for concern. There the Court considered the operation of the default beneficiary clause in the Trust Deed. The distributions had been:

1993 income year:

"Hendon Unit Trust 100%

and Resolved that should the Commissioner of Taxation disallow any amount as a deduction or include any amount in the assessable income of the Trust, such amount or amounts are to be deemed distributed on 30th June 1993 in the same proportions as listed above to the beneficiaries listed above".

1994 income year:

(a) The sum of $304,021.72 to Westside Commercial Centre Pty Ltd as trustee of the Hendon Unit Trust for its absolute benefit.

(b) The following sums to the following beneficiaries for their absolute respective benefits: NIL

(c) The Balance to Jessica Wagner and Bill Wagner equally between them for their absolute benefit.

1995 income year:

Hendon Unit Trust	*First $220,000*
Northbourne Trust	*Next $100,000*

Wilhelm J Wagner and Jessica O Wagner	*Remainder of balance equally*

4.80 The same "variation of income" clause as in 1993 applied in this year.

4.81 It would appear that the Trust Deed did not adopt subsection 95(1) terms and that income was ordinary income.

4.82 It was found that the Hendon Unit Trust was not an object of the Trust and the distribution of income to it failed. The default beneficiaries clause distributed income in default of appointment to the beneficiaries described in the Schedule to the Deed as tenants in common. This was the usual wide class of family objects.

4.83 The Court concluded that the default beneficiary clause did not operate as at 30 June because the trustee had a reasonable time after the end of the income year in which to decide to distributed or accumulate.

4.84 The question arose as to whether the balance clause in the 1994 and 1995 determinations operated to take the amounts which the Trustee had attempted to distribute to the Hendon Unit Trust to Mr and Mrs Wagner. It was concluded that this was not the effect of the distribution minute and, as a result, the Trustee was assessable under section 99A.

4.85 At [40] Cooper J concluded:

> *"In my judgment the submission is misconceived. In the 1994 income year the clear intention of the applicant was to appoint to Mr and Mrs Wagner only so much of the Trust income, if any, as exceeded $304,021.72 in addition to any income in excess of that amount in the event that the appointment to WCC should fail. The position is no different in respect of the 1995 year. The trustee purported to appoint discrete amounts of income to the Hendon Unit Trust as to the first $220,000 and to the Northbourne Trust as the next $100,000. Finally, as to any remainder after the application of the first $320,000 of income, that remainder was to be appointed to Mr and Mrs Wagner; they did not as a matter of construction or intention on the part of the trustee, take by default all of the income in the event of failure of the other two appointments."*

4.86 Rather than being a cause for concern about the "balance approach" the decision of Cooper J on this point supports its operation. The specific quantum entitlements fix the income (and tax where s 95(1) terms apply) at the amount specified in the Trustee's determination. If the gift fails it does not flow to the balance beneficiary but to the default beneficiary or, in the alternative, there is no such entitlement created, giving rise to a s 99A assessment to the trustee.

4.87 Further comfort can be obtained from observations made in *C of T v Ramsden* [2005] FCAFC 39. In that case the Court was concerned with the issue whether a beneficiary had effectively renounced a distribution of income.

4.88 The distribution minutes for the 1996 income year provided:

"Steve Hart Family Holdings No.2	*$17,295*
Steve Hart Family Holdings No.3	*$6,639*
Unlimited Aerobatic Discretionary Trust	*$34,810*
The Adcock Practice Trust	*$429,000*
Troy B Hart	*$4,750*
Steven I Hart	*The Balance"*

4.89 It was agreed that the Adcock Practice Trust did not qualify as a beneficiary. The default beneficiary clause provided for income which had not been appointed prior to year end to be held for Steven Hart and his three children as tenants in common. The ATO assessed each of the default beneficiaries to one quarter of the amount which had failed to be appointed to the Adcock Practice Trust.

4.90 The argument was pressed before the primary judge that the income should pass by way of the balance distribution to Steven Hart: Ramsden at [38] to [41]. Justice Spender's rejection of this argument was confirmed by the Full Court. It was observed at [2005] FCAFC 39 at [72]:

> *"We agree with this construction. 'The Balance' does not include the amounts which precede "The Balance" in the resolution of 30 June 1996.*
>
> *'The Balance' is the Income of the Trust for the year ended 30 June 1996 other than the amounts which precede it in the resolution in question, whether effectively appointed or not".*[2]

4.91 This observation supports the "balance approach" taken in this paper where there have been effective distributions. Note, however, that it will not work where a distribution is ineffective. In such a case the adjustment will be assessed to the default beneficiary, if there is one, or to the trustee.

Example (d) – Ordinary Income with balance approach applying

4.92 The trust law entitlements were:

	$
Child 1	3,000

[2] [2005] FCAFC 39 at para. 72.

Child 2	3,000
Mrs A	half of the balance
Mr A	half of the balance

4.93 Trust income entitlements:

	$
Child 1	3,000
Child 2	3,000
Mrs A	7,000
Mr A	7,000
	20,000

4.94 The tax law result was:

	$
Child 1	10,500
Child 2	10,500
Mrs A	24,500
Mr A	24,500
	70,000

4.95 When the tax law income is adjusted by $10,000 there is no change to the trust law result. The tax law result will be:

	$
Child 1	$10,500 + {}^{10,500}/_{70,000} \times \$10,000$
Child 2	$10,500 + {}^{10,500}/_{70,000} \times \$10,000$
Mrs A	$24,500 + {}^{24,500}/_{70,000} \times \$10,000$
Mr A	$24,500 + {}^{24,500}/_{70,000} \times \$10,000$

4.96 The final result will be:

	$
Child 1	12,000
Child 2	12,000
Mrs A	28,000
Mr A	28,000

	80,000

4.97 The result has only become worse from a Division 6AA income perspective.

Will a "default beneficiary" clause in the Deed assist?

4.98 An income default beneficiary clause would be expressed something like:

> *"If the Trustee has not determined to distribute all of the net income of the Trust by the end of the Income Year the Income Default Beneficiary will be absolutely entitled to that part of the net income which has not been distributed."*

4.99 The term "Income Default Beneficiary" will be appropriately defined to identify individuals or companies.

4.100 In Example (a) – subsection 95(1) terms but no "balance approach" – a default beneficiary clause would have deflected the tax adjustment from the trustee to the default beneficiary.

4.101 In Example (b) – ordinary income but no "balance approach" – the default beneficiary clause would have no effective operation as all of the trust law/tax law income has been accounted for.

4.102 The trust entitlements were:

	$
Child 1	3,000
Child 2	3,000
Mrs A	7,000
Mr A	7,000
	20,000

4.103 The tax law result was:

	$
Child 1	10,500
Child 2	10,500
Mrs A	24,500
Mr A	24,500
	70,000

4.104 If the tax law income is increased by $10,000 the trust law income does not alter. The tax law adjustment is apportioned according to the trust law income apportionments, as follows:

	$
Child 1	10,500 + $^{3,000}/_{20,000}$ x 10,000
Child 2	10,500 + $^{3,000}/_{20,000}$ x 10,000
Mrs A	24,500 + $^{7,000}/_{20,000}$ x 10,000
Mr A	24,500 + $^{7,000}/_{20,000}$ x 10,000[3]
	70,000

4.105 The final tax results will be:

	$
Child 1	12,000
Child 2	12,000
Mrs A	28,000
Mr A	28,000
	80,000

4.106 In Example (c) – subsection 95(1) terms and a "balance approach" – the default beneficiary clause has no role to play because the adjustment will always be directed to the balance beneficiary.

4.107 In Example (d) – ordinary income and "balance approach" – the default beneficiary clause has no need to operate because the tax adjustment will simply be apportioned in accordance with the trust law entitlements which don't change.

Summary re Tax Adjustments

Trust Accounting Basis	Tax Law Income	Trust Income	Adjustment to (if no default beneficiary)	Adjustment to (if there is a default beneficiary)
subsection 95(1) – no "balance approach"	+ $100	+ $100	Trustee	Default Beneficiary
subsection 95(1) – "balance approach"	+ $100	+ $100	Balance Beneficiaries	Balance Beneficiaries
ordinary income – no "balance approach"	+ $100	no change	All Beneficiaries	All Beneficiaries
ordinary income – "balance approach"	+ $100	no change	All Beneficiaries	All Beneficiaries

[3] The proportions remain the same whether the trust law or tax law results are used.

Guidance from Bamford

4.108 As the High Court observed in Bamford at [17]:

> *"… both sides in argument on the present appeals accepted that whichever of the competing constructions of Div 6 were accepted examples could readily be given of apparent unfairness in the resulting administration of the legislation"*

4.109 In reaching the conclusion that the terms of the Trust Deed determine the trust income to which a beneficiary may be made entitled the High Court has gone very far towards resolving most of the problems and uncertainties which confronted practitioners and the trustees and beneficiaries they advise. With a good understanding of the terms of the Trust Deed as they effect trust distributions most distribution problems can be addressed.

4.110 As has been demonstrated in the above worked examples adopting a s 95(1) terms plus "balance approach" achieves the following:

4.110.1 the quantum of tax distribution to children can be locked in.

4.110.2 any "normal" tax adjustment will flow to the balance beneficiaries.

4.110.3 if used in conjunction with a default beneficiary clause ineffective distributions can also be dealt with.

4.111 The subsection 95(1) but without a "balance approach" can lead to:

4.111.1 an assessment of the tax adjustments to the trustee under section 99A;

4.111.2 clawback of any general CGT discount.

4.112 This can be addressed by using a default beneficiary (of course the default beneficiary should not be a company where the general CGT discount is involved).

4.113 The balance approach together with a considered default beneficiary is to be preferred as the outcome is more predictable.

4.114 The ordinary income approach is problematic because it is:

4.114.1 too difficult to calculate what is net ordinary income;

4.114.2 and tax law adjustments will be spread across all beneficiaries (as there is no adjustment to the net income).

5. Div 7A Amendments

5.1 Division 7A of Part III of the 1936 Act deals with accessing wealth in private companies without accounting for the tax that would otherwise be payable on the value accessed. It focuses on three means of accessing wealth in private companies – payments from a private company, loans from a private company or the forgiveness of a debt by a private company to an associate of that company.

5.2 In 2010 there were two broad changes to the Division 7A interacts with trusts:

5.2.1 The Div 7A Amendments; and

5.2.2 The Commissioner's position in *Taxation Ruling 2010/3* and *Practice Statement Law Administration* 2010/4.

5.3 The changes to Division 7A include the insertion of an introductory note to Division 7A stating:

> An amount may also be included in the assessable income of a shareholder or shareholder's associate if:
>
> (a) a company has an unpaid present entitlement to income of a trust; and
>
> (b) the trustee makes a payment or loan to, or forgives a debt of, the shareholder or associate.
>
> (See Subdivisions EA and EB.)

5.4 This note is of interest as it strongly suggests that Subdivision EA is a 'code' which is intended to capture arrangements where there is an unpaid present entitlement subsisting between a trust and a corporate beneficiary and there is then a loan, payment or forgiveness that occurs between the trustee and a shareholder or an associate of a shareholder in the corporate beneficiary.

5.5 This should be contrasted with the position in the ATO *Taxation Ruling* 2010/3 where the ATO assert that subdivision EA has much more limited effect, where they generally restrict its operation to the situation where there is a sub-trust in existence between a trustee and a corporate beneficiary and there is then loan, payment or forgiveness involving a shareholder or an associate of a shareholder and the trustee of the sub-trust.

5.6 In the 31 March 2010 NTLG meeting the professional bodies questioned the ATO as to whether the introduction of this provision into Division 7A cast doubt on the position in their draft ruling. The meeting agenda includes the following discussion:

> The ATO does not see a conflict between the legislation of provisions dealing with unpaid present entitlements and the position set out in Draft Ruling TR 2009/D8.

This is because, contrary to the premise of the question, under Draft Ruling TR 2009/D8 unpaid present entitlements will retain that status for Division 7A purposes in many situations, including where:

- the amount representing the UPE is physically held on sub-trust for the sole benefit of the private company beneficiary;
- the amount representing the UPE is being used by the trustee but all benefits from this use are held for the sole benefit of the private company; or
- the private company beneficiary is not aware and cannot be taken to be aware that the funds representing its UPE are being used for the potential benefit of any or all discretionary objects of the trust (rather than being physically set aside or used for its sole benefit).

The ATO has appropriately consulted with Treasury prior to and during the drafting of TR 2009/D8.

Provisions within Division 7A dealing with unpaid present entitlements will continue to have their intended application and there is no inconsistency between the Exposure Draft legislation and the draft Ruling.

Use of assets

5.7 As was announced in the 2009/10 Federal Budget the use of assets owned by private companies, or owned by trusts where there is a present entitlement owing to a private company may be subject to tax after 1 July 2009.

5.8 The way in which the use of assets will become subject to tax is through the amendment of the definition of the term 'payment' in Division 7A so that it extends to the provision of an asset (other than a transfer of property) for use by an entity. Consistent with the present operation of Division 7A the provision of the asset will only result in Division 7A consequences where the asset is provided to a shareholder or associate of a shareholder.

5.9 For the purposes of Division 7A the payment will occur when the use of the asset occurs.

5.10 A payment will also arise however where the asset is not used, but is available for use. The examples in the EM are illustrative of when it will be the right to use the asset, and not its use, that is subject to the Division 7A rules.

> ***Example (right to use from EM)***
> ***Brian is a shareholder of a private company that owns a luxury yacht. He does not have a formal agreement with the company in relation to the yacht, however, he takes the yacht out every second weekend.***
>
> ***Brian keeps the yacht at the company's business premises, but takes the key home. Brian stores several personal items on the yacht.***
>
> ***Brian's fortnightly use of the yacht is a payment under Division 7A. The availability of the yacht for Brian's use is also subject to Division 7A because the yacht is not readily available for use by the company. The company would need to arrange with Brian to***

get the key and for the removal of Brian's personal items before using the yacht. That is, the asset is available for Brian's use to the exclusion of the company.

Example (use from EM)
Marina is a shareholder of a private company that owns a city apartment. The apartment is generally available for rent. However, Marina asks the company not to rent the apartment out for a week so that she and her family can use the apartment over a long weekend. Marina's use of the apartment is a payment for the purposes of section 109CA.

5.11 An issue that arose on consultation over the draft legislation giving effect to these changes was whether the mere availability of assets to a shareholder or associate would result in the shareholder or associate being treated as having the asset available for their use. The EM again includes an example where there a payment is not taken to arise where an asset is available as a result of a general entitlement to use an asset without actual use of the asset.

Example (mere entitlement from EM)
Peter is a shareholder of a private company that owns five cars for company use. Shareholders and their associates have general permission to use the cars on weekends if they are not being used for company business. Peter regularly takes one of the cars home.

Peter's use of the car that he takes home will be subject to Division 7A. This will include driving the car (actual use) and the availability of the car for his use to the exclusion of the company, such as when it is parked at home, or at a restaurant that Peter is visiting.

Although Peter may have general permission to use all five of the cars, he does not use all of them for the purposes of Division 7A. The four cars that Peter leaves at the company premises are available for the company to loan to another shareholder, employee, customer, or other party. That is, these cars are not available to Peter to the exclusion of the company.

5.12 The EM also includes examples of where an asset is available to more than one shareholder or associate and it is necessary to determine who is taxed. The EM suggests and apportionment of the taxable value to the person who is the real recipient of the benefit. One example sets out that a minor that benefits should not be taken to receive a Division 7A payment, where another sets out that incidental use by a spouse of a vehicle provided to a shareholder would not result in the spouse being taxed on the benefit provided.

5.13 In valuing the payment taken to be made it will be the amount that would have been paid for the use of the asset in an arm's length dealing less any consideration paid that will be determined to be the payment for Division 7A purposes.

5.14 There are a number of exceptions from the payment provisions applying, including one not previously announced dealing with residential property:

5.14.1 Minor benefits – if the provision of the asset would have been a minor benefit under section 58P of the FBTAA had it been provided to an employee then the benefit will be disregarded for Division 7A purposes

5.14.2 Otherwise deductible payments – if a once off deduction would have been available to the shareholder or their associate in connection with the use of the asset then there will be no benefit to be taken into account for Division 7A purposes.

5.14.3 Dwellings – the use of a dwelling can be exempt where the following conditions are satisfied:

5.14.3.1 the entity or their associate is carrying on a business;

5.14.3.2 the entity or their associate uses or is granted or has a lease, licence or other right to use land, water or a building for the purpose of carrying on the business; and

5.14.3.3 the provision of the dwelling to the entity is connected with that use or with that lease, licence or other right to use the land, water or building to carry on the business.

5.14.4 Main residences – the provision of a dwelling that is a person's main residence does not result in a Division 7A payment where:

5.14.4.1 The provider of the dwelling is a private company;

5.14.4.2 The private company acquired the dwelling before 1 July 2009; and

5.14.4.3 The private company would pass COT from the time that the dwelling was acquired until the end of the time that a payment could be taken to be made under Division 7A.

5.14.5 Vacant land – if the exception for a dwelling or a main residence applies, it will extend to adjacent land in the same way as occurs in the main residence exemption.

Corporate limited partnerships

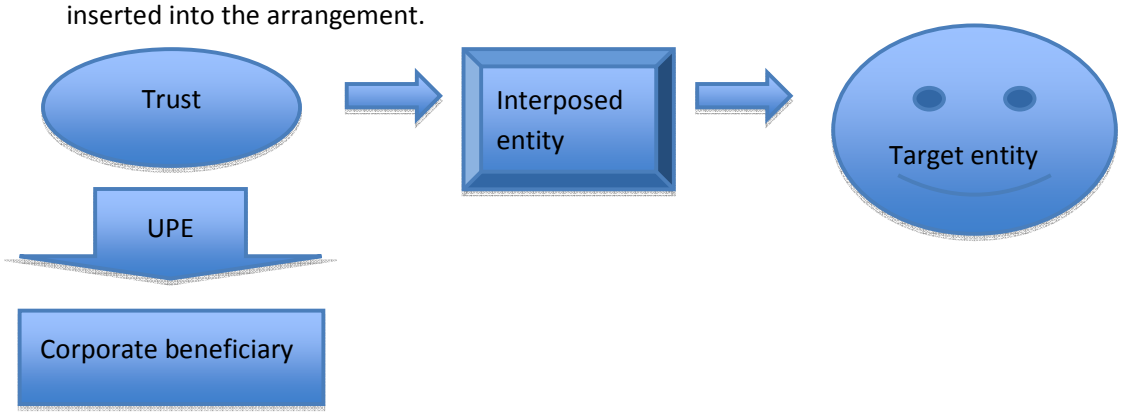
5.15 Closely held corporate limited partnerships (limited liability partnerships) will also now be subject to Division 7A. A corporate limited partnership will be closely held where it has fewer than 50 members or where an entity has, directly or indirectly, for the entity's own benefit, an entitlement to 75% or more of the income and capital of the partnership.

Interposed entities

5.16 The Div 7A Amendments fix two drafting issues in relation to the use of interposed entities.

5.17 The Division 7A legislation as originally drafted allowed for a payment by a private company through an interposed entity to be treated as a payment for Division 7A purposes.

5.18 The legislation did not however on a plain reading, allow for a trust where there was an unpaid present entitlement, to be deemed to have made a payment where an interposed entity was inserted into the arrangement.



5.19 A payment from the trust through an interposed entity to a target entity will now be caught by Division 7A if a reasonable person would consider that a loan or payment made to the interposed entity was made to enable a loan or payment to be made by the interposed entity to the target entity.

5.20 Consistent with the current operation of Subdivision EA however, a payment through to the target entity will only result in a Division 7A deemed dividend if it is referable to a reduction in a present entitlement that is in itself attributable to an unrealised gain in the trust.

5.21 The Div 7A Amendments also ensures that where an unpaid present entitlement is owed to a company by a trust, but the loan, payment or forgiveness that occurs does not involve the trust that owes the unpaid present entitlement, that Subdivision EA still has effect.

5.22 Subdivision EA will apply to treat a loan or payment from a trust as being a Division 7A loan or payment to the extent that the loan or payment is referable to an unpaid present entitlement owed to a private company where that amount has not already resulted in a Division 7A loan or payment.

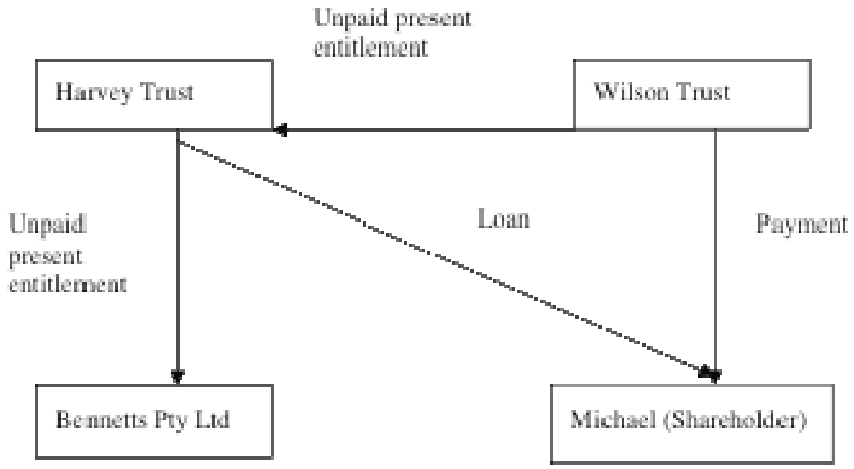
Example (interposed trust from EM)
Michael is a shareholder of Bennetts Pty Ltd and Bennetts Pty Ltd is a beneficiary of Harvey Trust. In the 2009-10 income year, Michael receives a payment from the trustee of the Wilson Trust, which is attributable to an unrealised gain. He receives this payment

because of his shareholding in Bennetts Pty Ltd. Michael also receives a $2,000 non-compliant Division 7A loan from the Harvey Trust.

Bennetts Pty Ltd is not presently entitled to an amount from the net income of the Wilson Trust. However, Bennetts Pty Ltd is entitled to $10,000 from the net income of the Harvey Trust (the first interposed trust) and Harvey Trust is presently entitled to $10,000 from the net income of the Wilson Trust. These amounts remain unpaid.

The loan made by the Harvey Trust to Michael will be included in Michael's assessable income under ordinary operation of subsection 109XA(2).

Bennetts Pty Ltd is taken to be presently entitled to $8,000 from the Wilson Trust, which is the unpaid present entitlement of $10,000 from the Harvey Trust, reduced by the $2,000 loan amount that is included in Michael's assessable income under another provision of Subdivision EA.



Loan back arrangements

5.23 Subdivision EA as currently drafted only captures payment arrangements where the payment is a reduction of a present entitlement that is referrable to an unrealised gain.

5.24 To circumvent these rules, apparently it had been suggested that the following arrangement could be entered into:

5.24.1 An unpaid present entitlement exists to a private company, say of $100,000.

5.24.2 A payment is made by the trustee of the trust to a beneficiary of an amount far in excess of the UPE, for example $1 million.

5.24.3 The amount in excess of the UPE is then loaned back to the trustee, being $900,000.

5.24.4 Thus, the beneficiary now has a credit loan of $900,000.

5.24.5 In future years the trustee appoints income to the company and uses the funds to repay the credit loan.

5.25 The need for there to be a payment referrable to a reduction of an unrealised gain will be removed where the payment made to a beneficiary is in reduction of a loan made on or after 1 July 2009 where a reasonable person would conclude that the trustee obtained the loan in order to make the payment.

Amendment to distributable surplus definition

5.26 The definition of distributable surplus will be amended so that amounts that have been deemed to be dividends as a result of the operation of Subdivision EA will be removed from the distributable surplus (by being correctly included as non-commercial loans).

Forgiveness of 109XB loans

5.27 There is a drafting problem that will be rectified so that the forgiveness of a loan by a trustee that has already been deemed to be a dividend will not result in a subsequent dividend. The law already applies in this way to the forgiveness of a debt owed to a private company by a shareholder that has already been deemed to receive a dividend under Division 7A.

Dividend set-off

5.28 Another drafting problem dealing with dividend set-offs will also be rectified.

5.29 At present, where a private company makes a loan that is deemed to be a dividend and later pays an unfranked dividend that is set off against that loan the later dividend is not included in assessable income.

5.30 The ability to disregard the later dividend does not apply where the loan was made by the trustee of a trust and where the deemed dividend arose under section 109XB.

5.31 The ability to disregard a later unfranked dividend offset against a loan from a trustee is being introduced.

Setting off employment entitlements

5.32 Another unusual aspect of the interaction of Division 7A generally and Subdivision EA has been that employment related payments that are offset against loans by trustees do not count as repayments if there is a borrowing of a similar or greater amount to the amount repaid. This is in contrast to setting off such a payment against a loan by a company where the repayment is taken into account even if there is a further borrowing.

5.33 This anomaly is to be rectified.

Borrowing to repay

5.34 Under the previous law a repayment is disregarded where the repayment is made where a reasonable person would conclude the repayment was made in order to borrow a similar or greater amount. This prevents a person from borrowing funds during a financial year, repaying on 30 June, and then reborrowing the amount on 1 July.

5.35 While the law has operated in this way (with some exceptions for repayments that occur by way of offsetting assessable amounts such as the wages noted above) it arguably has not operated where, instead of repaying to borrow, a person borrows to repay. This was be remedied so that a borrowing to repay will also activate section 109R.

> ***Example (from EM)***
> ***Alicia obtains a loan of $10,000 from Cleary Pty Ltd. Alicia has until the lodgment day to repay the loan. Two weeks before the lodgment day Alicia obtains a further $10,000 from Cleary Pty Ltd. She then repays the original $10,000 loan a week before the lodgment day.***
>
> ***The repayment of the original $10,000 loan is not a repayment for the purposes of section 109D, because Alicia has borrowed a similar amount from Cleary Pty Ltd and in this case a reasonable person would conclude that the loan was obtained in order to make the repayment of the original $10,000.***
>
> ***The original $10,000 loan is treated as a deemed dividend subject to the distributable surplus of the private company.***

Adding back payments for Division 7A purposes

6. Streaming

6.1 The paper will no consider the importance of, and ability to, stream as it stood before the Streaming Amendments. Then it will consider the Streaming Amendments.

Pre-Streaming Amendments

6.2 As can be seen from the illustrations above the ability to stream income according to its character is very important. This is particularly the case for franked dividends and capital gains but there are other forms of income with tax characteristics that may also be important e.g. income from a foreign source, income which has been subject to TFN withholding tax.

6.3 The decisions in Bamford tell us nothing about streaming income for tax purposes.

6.4 Most modern trust deeds will give the trustee power to distinguish between classes of income and to characterise a particular amount of income as having been derived from a particular source. The Deed should also allow the trustee to allocate expenses to the different classes of income.

6.5 The law regarding streaming after the decision in *CPT Custodian Pty Ltd v Commissioner of State Revenue [2005] HCA 53* ("**CPT Custodian**") was quite uncertain. The decision of the High Court in *Charles v C of T [1954] HCA 16* ("**Charles**") has always been the centre of gravity of the character flow through approach. The decision in Charles was heavily criticised by the Court in CPT Custodian. The question is whether that criticism went to the maintenance of character or is restricted to the characterisation of the interest in the trust fund by looking through to the underlying assets.

6.6 The decision of the High Court in CPT Custodian, in the writers' views, stands for the proposition that a beneficiary has an equitable interest in the residue of the trust fund after the Trustee's indemnity has been satisfied. This residue is characterless, whether it be income or capital, as the trustee may at any time satisfy its right to be indemnified from the receipts (which themselves have character).

6.7 Notwithstanding these problems the ATO has consistently taken the view that the character of the income in the hands of the beneficiary is taken from the character of the receipts of the Trustee[4] even after taking into account the decision in *CPT Custodian*[5].

6.8 In the non-binding ruling IT2328 (now withdrawn) it was observed:

> *"For income tax purposes where a beneficiary in a trust estate is presently entitled to the net income or a share of the net income of the trust estate, that income as a general principle has the same character in the hands of the beneficiary as it had in the hands of the trustee."*

6.9 The most significant streaming issues concern capital gains and dividends. In the case of capital gains Division 115 of Part 3-1 of the 1997 Act proceeds on an implication that income entitlements will take on at least some part of the character of the capital gains derived by the trustee. There is no clear legislative follow through. The guidance found in Sesction 115-200 of the 1997 Act establishes the implied maintenance of character:

> *"This Subdivision sets out rules for dealing with the net income of a trust that has a net capital gain. The rules treat parts of the net income attributable to the trust's net capital gain as capital gains made by the beneficiary entitled to those parts."*

[4] see in particular ATO ID 2008/51 dealing with Division 13.3A of the SIS Regulations.

[5] see Taxation Ruling STR 92/13, IT2328, IT2512, IT2004 (withdrawn) and ATO ID 2007/108 (which is concerned with foreign sourced income and in respect of which subsection 6B(2A) of the 1936 Act also comes into consideration).

6.10 Subsection 115-215(1) is the nub of the provisions:

> *"The purpose of this section is to ensure that appropriate amounts of the trust estate's net income attributable to the trust estate's capital gains are treated as a beneficiary's capital gains when assessing the beneficiary, so:*
>
> *(a) the beneficiary can apply capital losses against gains; and*
>
> *(b) the beneficiary can apply the appropriate discount percentage (if any) to gains."*

6.11 The process is described as attribution rather than maintenance of source character. This may be the necessary distinction to make the rules work. There is, however, no guidance about how the attribution is to be carried out.

6.12 What is clear is that if there is no trust income to which the beneficiary is presently entitled there can be no attribution. This is a major issue where there is no trading income but there are capital gains in the Trust. Use of s 95(1) terms to describe income overcomes this problem and makes the case for attribution much clearer. The capital gain (or at least 50% of it) will be included in the income. The connection for Subdivision 115-C purposes is very clear.

6.13 The ATO has had to resort to the artificiality of the "capital beneficiary approach" in PS LA 2005/1 (GA) to achieve this sensible outcome – but this practice statement was withdrawn following Bamford.

6.14 The issues with streaming can be readily appreciated in the context of capital gains and the 50% general CGT discount. The streaming issue is, of course, the denial of the 50% CGT general discount when a trust to company distribution is in play.

6.15 Maintaining the example used above in which there is a net capital gain of $100,000, and gross rental income of $50,0000 and net rental income of $20,000.

6.16 In this instance the trustee wishes to cause the capital gain to be assessed in the hands of an individual (say Mrs A) and the net rental income in the hands of a company, A Co. If it is assumed that the Trust Deed has all of the usual income characterisation and streaming provisions and the Deed adopts subsection 95(1) terms, the outcome readily appears.

6.17 The income entitlements are:

	$	
A Co	20,000	comprising net rental income
Mrs A	50,000	comprising the capital gain
	70,000	

6.18 If the ATO took the view that streaming was unobtainable the outcome would be:

	$	$ Total
A Co	5,714 + taxable capital gain $28,572	34,286
Mrs A	50,000	50,000
		84,286

6.19 The other area of concern is franking credits. At least there is a ruling on this aspect of streaming, *Taxation Ruling* 92/13 (repealed as of 22 June 2011 because of the Streaming Amendments). The provisions of Subdivision 207-B and in particular ss 207-45 to 207-57 are consistent with flow through of the franked character of a dividend.

6.20 The fact the Example set out immediately below s 207-35(3) of the 1997 Act depends on character maintenance. It is worthwhile setting this Example out in full:

> *"A franked distribution of $70 is made to the trustee of a trust in an income year. The trust also has $100 of assessable income from other sources. Under subsection (1) the trust's assessable income includes an additional amount of $30 (which is the franking credit on the distribution). The trust has a net income of $200 for that income year.*
>
> *There are 2 beneficiaries of the trust, P and Q, who are presently entitled to the trust's income. Under the trust deed, P is entitled to all of the franked distribution and Q is entitled to all other income.*
>
> *The distribution flows indirectly to P (as P is entitled to a share of that net income and has a 100% share of the distribution under section 207-55). P therefore has an amount of assessable income that is equal to its share of the distribution. Under this subsection, P's assessable income also includes the full amount of the franking credit (as P's share of the franking credit on the distribution is $30 under section 207-57). Q's share of the net income therefore does not include any of the franking credit."*

6.21 Clearly the legislation contemplates maintenance of character for the purposes of dividend imputation.

Commissioner's Concern of Division 6 Abuses

6.22 As usual the ATO is driven by the possibility that the decision in Bamford might support some abuse and revenue loss. No matter that their interpretations lead to massive headaches for practitioners.

6.23 This much is exampled by several examples set out *in Practice Statement PS LA 2009/7* which was released prior to the decision in Bamford.

6.24 Examples 1 and 5 in particular show what the ATO is on about.

6.25 Example 1 concerns the trustee of a family trust deriving $250,000 in income during the income year and applying that income to the purchase of a holiday home. The trustee, acting in accordance with a power expressed in the terms of the Trust Deed to do so, determines that the expenditure on the purchase of the house is an outgoing on income account with the effect that the trust law income available for distribution is $5,000. One of the beneficiaries has tax losses.

6.26 The trustee distributes the $5,000 trust law income to the loss beneficiary. The losses cover the tax law income which follows the trust law income to the loss beneficiary.

6.27 The ATO expresses concern about the mismatch of the actual amount to which the beneficiary becomes entitled ($5,000) and the amount of the tax law income flowing to the beneficiary ($250,000) and the tax not paid because of the losses.

6.28 It is difficult to say why this is of concern to them. The true effect of the transaction is to maintain $245,000 in the capital of the trust. The same tax effect would be obtained by distributing all of the $250,000 to the loss beneficiary. There is no tax difference in this illustration. It is unlikely there would be a tax benefit for the purposes of Part IVA. The most likely explanation for the transaction is the financial risk the loss beneficiary has been exposed to. If the beneficiary became entitled to call on the trustee to pay him or her $250,000 the creditors may be able to stake a claim to that amount. It is a neat and sensible piece of asset protection planning.

6.29 Example 5 is about a trust which has distinct income and capital beneficiaries. The trustee has a power to determine whether receipts and outgoings are on income or capital account. The Trust Deed is amended to admit a tax exempt entity as a beneficiary.

6.30 The trust derives $100,000 of income (meaning income according to ordinary concepts) during the income year. The trustee determines that $95,000 of that amount is a capital receipt. The remaining $5,000 is the trust law income according to the Trust Deed. This amount is appointed to the tax exempt beneficiary. All of the tax law income will be assessed to the charity. It would follow that the trustee makes a capital distribution of the $95,000 to a family beneficiary.

6.31 The ATO observe in the Practice Statement that Part IVA might apply in the circumstances. In the writer's view it almost certainly would do so in particular because of the amendment to introduce the tax exempt charity as a beneficiary and the fact that prior year distributions had been made only to family members. A much more challenging (and perhaps more realistic) illustration would arise if the tax exempt charity was already an object and the trustee had made distributions to charities in the past. The Part IVA case in such circumstances would be difficult to make out. This is an example of the acknowledged "apparent unfairness in the resulting administration of the legislation" as noted by the High Court in Bamford at [17].

6.32 The ATO apparently accept that Bamford authorizes characterization of capital receipts as income for the purposes of the Deed but are not so ready to accept that ordinary income may be recharacterised as capital (as in Example 5). They appear to be fortified in this by observations made by the Full Court of the Federal Court in *Forrest v C of T* [2010] FCAFC 6 ("**Forrest**").

6.33 The relevant question before the Court there was whether Mr Forrest was entitled to a deduction for interest he had incurred in relation to funds he had borrowed to acquire units in a unit trust. The outcome turned on whether there was a fixed income component to which the funds related. The Full Court concluded that a power to determine whether any amount received by the trustee was on revenue account or capital account (clause 12 of the Deed) was not a power to change the beneficiaries' rights. In so doing they observed at [11]-[12]:

> *'In our opinion, the power conferred by cl. 12 cannot be exercised by the trustee wrongly to classify a receipt as a capital gain, when the receipt is, in truth, income, and thus deprive the appellant of his interest in the unit component of the trust. Clause 12 is not an unlimited power to be exercised in the trustee's unconfined discretion….*
>
> *Clause 12.2(a) is a power to determine how a distribution to beneficiaries is classified. That limited power is not a power which is capable of altering the beneficiaries' rights. Clause 12 is to be read consistently with the balance of the Trust Deed and an appreciation that it contains various powers of an administrative character. The words used can be given full force honestly to classify income or distributions according to law, as the appellant contended to this Court".*

6.34 It is very difficult to know how far this goes. The issue in Forrest was about whether or not the exercise of the power changed the rights as between classes of beneficiaries. Presumably the ATO would say that the exercise of the power in a case like that in Example 5 was not an "honest" classification of the receipt as capital. Hopefully the issue will not arise very often.

Point of Interest

6.35 A case of interest is *Greenhatch v FCT* [2011] AATA 479 that ostensibly concerned superannuation contributions where the answer to the superannuation question was determined by construing streaming through a trust. The case of is interest for two reasons.

6.36 First, the AAT went out of their way to note the Commissioner's interpretation of Bamford was wrong. At [49] and [50] they said:

> *Much, if not all, of the Commissioner's case turns on his rejection of any underlying conduit theory and his interpretation of the implications of the decision in Bamford.*

The Commissioner's contention that the conduit theory has no role to play is based on foundations with which we do not agree. Accordingly, those foundations do not support the conclusion he seeks to draw.

6.37 Secondly, in relation to Subdivision 207-B of the 1997 Act, being the franking credits provisions, the AAT observed at [63]:

> *Section 207-35 of the 1997 Act has an aspect that makes the conclusion [that] amounts passing through trusts to beneficiaries thereof carry the character and identity that they had in the hands of the trustee more compelling. That section includes an example that contemplates differential distributions in determining the taxation burdens that are imposed on the beneficiaries of the trust.*

6.38 Question: was it necessary to introduce the Streaming Amendments in light of the above comments? Given we have the Streaming Amendments it is of academic interest only.

Streaming Amendments

6.39 The *Tax Laws Amendment (2011 Measures No. 5) Act* 2011 (Cth) was introduced into parliament (as a Bill) on 2 June 2011, was passed unamended and assented to on 29 June 2011. They take effect from 1 July 2010. These dates show how close a call it was as the Streaming Amendments are critical for trustee decisions that were needed to be made on 30 June 2011 – one day after their royal assent.

6.40 Subject to a statement by the Commissioner – extending the time a trustee could make decisions to 31 August 2011, which has anyway passed, but the writers question the Commissioner's ability to alter what trust law[6] requires to be done on 30 June of any year – the Streaming Amendments apply to trustees resolving to deal with trust income and capital gains.

6.41 From the 2011 income year and thereafter taxable capital gains and franked distributions are dealt with under these rules.

6.42 The Streaming Amendments operate by diverting from Division 6 of the 1936 Act the franked distributions and taxable capital gains. They are assessed directly in the hands of the beneficiaries who are presently entitled to them. They do this via Subdivision 207-B of the 1997 Act for franked distributions and via Subdivision 115-C of the 1997 Act for taxable capital gains. However, for the taxable capital gains they must still pass through the method statement in s 102-5(1) of the 1997 Act.

[6] *Trustees of the Estate Mortgage Fighting Fund Trust v FCT* [2000] FCA 981 per Hill J; *Case R105,* 84 ATC 692; *Antonopoulos v FCT* [2011] AATA 431.

6.43 The Streaming Amendments have introduced a new Division 6E into Part III of the 1936 Act to prevent double taxation. It adjusts the Division 6 income and net income of the trust to take out the amounts to which the beneficiary has been made specifically entitled.

6.44 It can be seen that the specific entitlement of the beneficiary or beneficiaries is the critical aspect of the Streaming Amendments. This is required to determine tax liability.

Specific Entitlement

6.45 The notion of a specific entitlement conceals the difficulties of applying the Streaming Amendments to all trusts, be they discretionary, fixed, unit, et cetera. The mechanism by which you become specifically entitled are set out in the relevant Subdivisions: s 115-228 for capital gains and s 207-58 for franked distributions. The provisions seem substantially similar at first look but there are some significant differences.

6.46 A beneficiary is specifically entitled under s 207-58 of the 1997 Act to an amount of a franked distribution made by the trust equal to the amount calculated under the following formula

$$\text{Franked Distribution} \times \frac{\text{Share of net financial benefit}}{\text{Net financial benefit}}$$

6.47 The "net financial benefit" is an amount equal to the financial benefit referable to the franked distribution (after an application by the trustee of expenses that are directly relevant to the franked distribution).

6.48 The term "financial benefit" is already in s 995-1 f the 1997 Act. It means anything of economic value, even if the transaction also imposes an obligation on the entity. Benefits and obligations are to be looked at separately and not set off against each other, but it is the net financial benefit to which the formula looks.

6.49 The "share of the financial benefit" is the amount of the financial benefit referable to the franked distribution specifically linked to the particular beneficiary. The share of the net financial benefit is:

> *… an amount equal to the *financial benefit that, in accordance with the terms of the trust:*
>
> *a. the beneficiary has received, or can be reasonably expected to receive, and*
>
> *b. is referable to the *franked distribution (after application by the trustee of any expenses that are directly relevant to the franked distribution) and*
>
> *c. is recorded, in its character as referable to the franked distribution, in the accounts or records of the trust no later than the end of the income year.*

6.50 Section 115-228 is identical to the discussion above of franked distributions, subject to:

6.50.1 the financial benefit must be referable to the capital gain "after application by the trustee of any losses, to the extent that the application is consistent with the application of capital losses against the capital gain in accordance with the method statement in subsection 102-5(1)"; and

6.50.2 the recording of the financial benefit must be "no later than 2 months after the end of the income year."

Complexities and Going Forward

6.51 An issue to be mindful of is – in fact an issue of significant importance – is that a trust with no "income", which was one of the problems in the Bamford appeals, will not be able to stream franking credits. This will mean that where the franked distributions, together with other ordinary income, is insufficient to more than offset expenses of the trust the franking credits cannot go through to the beneficiaries. The same restriction does not apply in relation to capital gains streamed through the trust.

6.52 Ken Schurgott FTIA, in his paper in the August 2011 *Taxation in Australia* titled "Trust streaming 2011" notes a number of complications that arise from the Streaming Amendments:

> *As will be seen, there are a number of issues which emerge that complicate the legislation over and beyond the rather simple approach adopted prior to the Commissioner's stance on streaming. The things which complicate matters are:*
>
> *a. There can be different outcomes according to the definition of income adopted by the trust deed;*
>
> *b. Significantly different outcomes can result where a beneficiary has not been made specifically entitled to the franked distribution or capital gain. This is most pronounced in relation to capital gains;*
>
> *c. The concept of making a beneficiary entitled to the entire financial benefit from a capital gain or franked distribution is fraught with difficulty, particularly where there are capital losses or directly related expenses; and*
>
> *d. The way in which capital losses and directly related expenses are to be dealt with is confusing.*

6.53 It can be seen from these further issues, and the problem of actually apply what is a simple concept of diverting the amounts to Subdivisions 115-C and 207-B respectively, are anything but straightforward or settled. Indeed, a senior council on the writer's floor, after having advised on

the Streaming Amendments is of the view that this is where future archeologists will find the bones of 21st Century tax lawyers and accountants.

7. Changes to the taxation of trusts – terms to be provided for in a trust document

7.1 Given the changes in the taxation of trusts, it is recommended that trust deed (or any other constituent documents) be reviewed so as to determine:

7.1.1 How income, capital gains and outgoings are accounted for and determined; and

7.1.2 How income, capital gains and outgoings are to be distributed.

7.2 Some of the powers which may be advantageous to have within a trust instrument include:

7.2.1 an accounting policy which is sufficiently broad and allows the trustee to exercise maximum discretion;

7.2.2 the discretion to reclassify and allocate income and capital gains;

7.2.3 the discretion to reclassify and allocate outgoings;

7.2.4 the discretion not to recoup losses (whether income or capital in nature);

7.2.5 the ability to allocate and stream classes of income and capital and their related tax attributes;

7.2.6 and ensure that any unpaid present entitlement / loan provisions are removed, and an ability to hold amounts subject to a sub-trust.

7.3 Some additional powers to be considered include:

7.3.1 whether the trustee has the power to distribute income and / or capital at any time within a tax year;

7.3.2 whether any determination of income (or capital) can be made within the income tax year; and

7.3.3 whether the trustee has a power to determine entitlements with respect to an income tax year after the relevant year.

Accounting policy

7.4 Essential is ensuring that the trust deed provides guidance with respect to an accounting policy that should be used by the trustee. Such an accounting policy should provide sufficient flexibility for the trustee, so that it may depart from generally accepted accounting standards in the event that the trustee considers that it is appropriate to do so.

Reclassifying and allocating income and capital

7.5 As the High Court in *Bamford* accepted that the tax law income of a trust is dependent upon (amongst other things) the definition of that term in the trust deed, regard should be given to the definition of the 'income' as contained in the trusts constituent documents.

7.6 An issue to consider is whether attributed amounts (e.g. franking credits) should be included within the definition of trust income. An issue that arises is that if attributions are included in trust income (and which are not physically 'paid' by a trustee – but which follow certain amounts of income), whether by being included in trust income, and thereby providing that a trustee creates a 'present entitlement' in a beneficiary to an amount that is never received by a trustee, the trustee will be exposed to a claim in relation to amounts that are not actually received by the trustee.

7.7 It is submitted that amounts such as franking credits should be prima facie carved-out of the definition of income. However, the definition should contain discretionary elements to allow a trustee to cause such 'attributed' amounts to fall within the definition of income.

7.8 An approach which may be considered is, in defining trust income:

7.8.1 Provide that it prima facie equals the amount provided for in s 95(1) of the 1936 Act (less any franking credits);

7.8.2 If the tax law approach is not warranted for a particular tax period, then:

7.8.2.1 According to an accounting policy adopted by the trustee; or

7.8.2.2 Any other basis as determined by the trustee; or

7.8.3 In the trustee's absolute discretion, the gross income of the trust.

Reclassifying and allocating outgoings

7.9 In *Cajkusic v FC of T (No 2)* (2006) ATC 4752 ("**Cajkusic**") deductions allowable to a family discretionary trust for payments that were made under an employee benefits trust arrangement in the income tax years ending 30 June 1997 and 30 June 2008 caused there to be a loss within the trust estate.

7.10 As a result of the losses, there was no distributable income of the trust. As a result, the Full Court of the Federal Court held that the lack of distributable income meant that there could be no beneficiary of the trust (for the relevant income tax years) to be "*… presently entitled …*'"pursuant to s 97 of the 1936 Act to any amount.

7.11 It should be noted that the Commissioner's subsequent application for special leave to appeal to the High Court was rejected.

7.12 Cajkusic stands for the proposition that the 'distributable income' of a trust is determined by reference to proper accounting principles, as well as the terms of a trust deed. In this context distributable income is income determined according to accounting principles, and which is distributable amongst the beneficiaries. It does not alter either the income as calculated under accounting principles, of the 'net income' as determined under s 95(1) of the 1936 Act – rather, only gives a trustee the power to determine the distributable amounts.

7.13 As a result of the decision in Cajkusic, it is submitted that a trust deed should give a trustee the power to reclassify, and allocate outgoings, so that there can be 'distributable income' to which beneficiaries are presently entitled.

Discretion not to recoup losses (whether income or capital in nature)

7.14 It is recommended that a trustee have a discretion not to recoup losses (whether of an income or capital nature). That is, a power not to recoup losses which have arisen in the past.

8. Resettlement considerations

8.1 Whenever the terms of a trust are varied, an issue to consider is whether the variation amounts to a 'resettlement'.

8.2 Resettlements relate to changes to a trust relationship which have the effect that a new trust estate comes into existence. According to the High Court in *FC of T v Commercial Nominees of Australia Ltd* [2001] HCA 33 (***"*Commercial Nominees"**), the issue to determine is whether '*… what occurred* … [i.e. the variation] … *was a fundamental alteration in the trust relationship*

established by the original deed, such that it destroyed the necessary continuity of the 'taxpayer'…'.

8.3 A resettlement can have significant income tax, capital gains tax (**'CGT'**) and stamp duty consequences, including that:

8.3.1 the trust property may be disposed of, potentially triggering both stamp duty and CGT liabilities;

8.3.2 carried forward tax benefits may be lost; and

8.3.3 beneficiaries may dispose of their interests in the original trust and acquire interest in a new trust.

8.4 Specifically in the context of CGT, a resettlement may cause either CGT event E1 (s 104-60 of the 1997 Act) or CGT event E2 (s 104-65 of the 1997 Act) to happen.

8.5 In August 2001 the issued a Statement of Principles entitled *Creation of a new trust* (the **"Statement**"). The Statement clarifies when, in the Commissioner's view, changes to a trust gives rise to a new trust. The Commissioner considers that a new trust estate arises where there is a 'fundamental change to a trust relationship' – ie, a change in the essential nature and character of the original trust relationship. Further, the Commissioner considers that a new trust (i.e. a resettlement) may arise in the following circumstances:

- a change in beneficial interest in trust property;
- a new class of beneficial interest (whether introduced or altered);
- a redefinition of the beneficiary class;
- changes in the terms of the trust or the rights or obligations of the trustee;
- changes in the nature of the trust property;
- additions of property which could amount to a new and separate settlement;
- depletion of trust property;
- a change in the termination date of the trust;
- a change in the trust that is not contemplated by the terms of the original trust;

- a change in the essential nature and purpose of the trust; and / or
- a merger of two or more trusts or a splitting of the trust.

8.6 The Commissioner considers that depending on their nature and extent, the above changes may either amount to:

8.6.1 a variation of a continuing trust; or

8.6.2 a fundamental change in the essential nature and character of the trust relationship. In such a case, the original trust may be brought to an end and a new trust created. Whether a new trust is created depends on the terms of the original trust and on the powers of the trustee.

8.7 The High Court in Commercial Nominees held that significant changes to a superannuation fund trust deed did not create a new trust, even though the amending deed had:

8.7.1 changed the name of, and appointed a new trustee to the fund;

8.7.2 introduced a new category of beneficiaries;

8.7.3 changed the fund from a defined benefit fund to an accumulation fund;

8.7.4 appointed a professional management company as administrator; and

8.7.5 allowed membership to be promoted to the public.

8.8 The High Court in *Commercial Nominees* considered that there were three main indicators of the continuity of a trust relationship, being:

8.8.1 the constitution of the trust;

8.8.2 the trust property; and

8.8.3 the membership of the trust.

8.9 Substantial changes any of the above may cause a resettlement.

8.10 The High Court considered that, in order to destroy the necessary continuity, changes in one or more of the above indicators must be such as to terminate the existence of the entity, or to produce the result that the particular trust does not derive the income in question. It was held that the changes made to the trust deed in question were not sufficient to destroy the continuity, primarily because the fund was at all times governed by the same deed, the trust property did not change, and the members before the amendment to the trust deed remained members afterwards. We consider that the amendments discussed above will not cause a resettlement.

8.11 The Commissioner notes in the Statement that administrative changes, such as re-defining trust income (without more) may not cause a resettlement (depending on the context) as it may be administrative in nature.

8.12 However, regard will need to be given to the implications to the membership (i.e. the beneficial entitlements) of the trust, and what implications such an amendment will have on the respective entitlements in a trust. For example, an important consideration will be determining how unallocated / undistributed income is to be dealt with. For example, is such income:

8.12.1 accumulated, and form part of the corpus of the relevant trust estate;

8.12.2 is it distributed to certain default beneficiaries; or

8.12.3 is it held on trust for a specific purpose (e.g. a charitable purpose).

Changes in the Taxation of Trusts

A paper presented by Michael Bennett and Denis Barlin at the NSW Young Lawyers CLE

Law Society of NSW, 7 September 2011

Michael Bennett E bennett@sevenwentworth.com.au D 8224 3055 M 0408 029 416
Denis Barlin E dbarlin@wenworthchambers.com.au D 9231 6646 M 0404 848 311

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1. General overview

1.1 The income years ended 30 June 2010 and, more particularly, 30 June 2011 have been very active for the taxation of trusts. Significant events in three areas of trust taxplay activity:

1.1.1 decisions of the Courts and principally the High Court's decision in *Commissioner of Taxation v Bamford* (2010) 240 CLR 481; (2010) 264 ALR 436; [2010] HCA 10 ("**Bamford**");

1.1.2 legislative changes, principally:

1.1.2.1 the new rules set out in *Tax Laws Amendment (2011 Measures No. 5) Act* 2011 (Cth) (the "**Streaming Amendments**") that deal with taxation of franking credits and capital gains in trusts; and

1.1.2.2 the new rules set out in the *Tax Laws Amendment (2010 Measures No. 2) Act* 2010 (Cth) that are principally about Division 7A of Part III of the *Income Tax Assessment Act* 1936 (Cth) (the "**1936 Act**") and companies providing rights to use property, but also contain some trust issues (the "**Div 7A Amendments**"); and

1.1.3 Australian Taxation Office ("**ATO**") activities principally the very controversial draft ruling on unpaid present entitlements, TR 2009/D8.

1.2 Some of these changes have overtaken themselves. For instance, there was at the time – and this paper includes – a discussion of streaming post Bamford (see **heading 4** below). That discussion should be read as having been overtaken by the Streaming Amendments (see **heading 5**).

1.3 And what's more the change is not over. Chapter 2 of the explanatory memorandum to the Bill that introduced the Steaming Amendments makes it clear that the streaming provisions have been introduced as an interim measure to deal with perceived anomalies in the taxation of capital gains and franked distributions pending a comprehensive review of Division 6 of Part II of the 1936 Act.

1.4 The changes made so far give rise to issues themselves and further consequential issues for trusts. In addressing the issues – both outlined above and the consequential issues – this paper will discuss:

1.4.1 Taxation of trusts generally;

1.4.2 The competing views before Bamford;

1.4.3 The context of Bamford and what it means for trusts;

1.4.4 Briefly (as it is not germane to the other issues raised in the paper) what are the Div 7A Amendments and what they mean for trusts;

1.4.5 What are the Steaming Amendments and what they mean for trust;

1.4.6 What a trust deed needs in light of those three issues; and

1.4.7 Amending trust deeds to deal with those three issues.

1.5 The issues are dealt with in this order as they are chronological to their occurring.

2. Taxation of Trusts

2.1 The provisions dealing with the taxation of trust income are contained in Division 6 of Part III of the 1936 Act (which comprises of sections 95 to 102).

2.2 As a result of the enactment of Streaming Amendments, regard should also be given to:

2.2.1 Subdivision 207-B of the *Income Tax Assessment Act* 1997 (Cth) (the "**1997 Act**") – which deals with franking credits obtained by a trust estate; and

2.2.2 Subdivision 115-C of the 1997 Act – which deals with the distribution of capital gains by a trust estate.

2.3 Chief Justice Latham in *Tindal v FC of T* (1946) 72 CLR 608 at 618 observed that the object of Division 6 of the 1936 Act is to "*… secure payment of tax upon the whole of the net income of a trust estate, either from a beneficiary or the trustee, whether the income is paid over to or on account of the beneficiary …*". Further, according to Emmett J in *Bamford v Federal Commissioner of Taxation* (2009) 176 FCR 250 "*… an important assumption underlying Division 6 …* [is] *… that a beneficiary who derives a share of the net income should be in a position to pay out of that income; otherwise, the beneficiary could be placed in a difficult position*."

2.4 The starting point in determining the taxation of trust income is s 97 of the 1936 Act. Relevantly, s 97(1) of the 1936 Act 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; and

(b) the exempt income of the beneficiary shall include:

(i) so much of the individual interest of the beneficiary in the exempt income of the trust estate as is attributable to a period when the beneficiary was a resident; and

(ii) so much of the individual interest of the beneficiary in the exempt 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;

except to the extent to which the exempt income to which that individual interest relates was taken into account in calculating the net income of the trust estate; and

(c) the non-assessable non-exempt income of the beneficiary shall include:

(i) so much of the individual interest of the beneficiary in the non-assessable non-exempt income of the trust estate as is attributable to a period when the beneficiary was a resident; and

(ii) so much of the individual interest of the beneficiary in the non-assessable non-exempt 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]

2.5 That is, s 97 of the 1936 Act provides that where a beneficiary, who is not under a legal disability is presently entitled to a "*… share of the income of the trust estate …*", the assessable income of:

2.5.1 a resident beneficiary includes the beneficiary's share of the '*… net income of the trust estate …*'; and

2.5.2 a non-resident beneficiary includes so much of the beneficiary's share of the net income of the trust as is attributable to sources in Australia.

2.6 It should be noted that the term "net income of the trust estate" for the purposes of s 97 of the 1936 Act is defined in s 95(1) of the 1936 Act. However, the term "*… the income of the trust estate …*" as contained in s 97 of the 1936 Act is not defined in the 1936 Act.

2.7 Subsection 95(1) of the 1936 Act defines the term 'net income', in relation to a trust estate as:

> ***net income**, 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 Division 393 of the Income Tax Assessment Act 1997 (Farm management deposits) 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.*

2.8 For completeness, it should be noted that:

2.8.1 s 98 of the 1936 Act provides that the trustee is liable to tax on behalf of a beneficiary where the beneficiary is presently entitled to a share of the income of a trust estate, but the beneficiary is under a legal disability;

2.8.2 ss 99 and 99A of the 1936 Act apply to subject the trustee to tax where there is some part of the net income of a trust estate that is not subject to tax under either of ss 97 or 98 of the 1936 Act. The difference as between s 99 and s 99A of the 1936 Act is the rate of tax applicable. Typically, the trustee will be subject to tax under section 99A of the 1936 Act at a penal rate of tax equal to the maximum rate of tax (currently 45%). However, the Commissioner has a discretion to apply s 99 of the 1936 Act in certain circumstances, in which case the trustee will be subject to tax at the normal marginal rates of tax.

3. The two competing views before the decision in Bamford

3.1 There has been, for some time, two competing views in the taxation of trust income – the proportionate view and the quantum view.

Proportionate approach

3.2 *David & Anor v FC of T* 89 ATC 4377 contains an example of the application of the proportionate approach (which according to the High Court's decision in Bamford, is the correct approach).

3.3 The proportionate view looks to the share (or proportion) of trust law income of a trust to which a beneficiary is "presently entitled", and then applies that share or proportion to the net income of a trust estate to calculate how much of the net income is to be included in the beneficiary's assessable income.

3.4 As an example, if a beneficiary is entitled to one half of the trust law income, then the beneficiary must include half of the net income in their assessable income – irrespective of whether it is more or less than the amount of the trust law income to which they are entitled.

(a) Implications if tax law income exceeds trust law income

3.5 Under this approach, a beneficiary who is "presently entitled" to trust law income may be required under s 97(1) of the 1936 Act to include in their assessable income an amount of net income which is greater than the amount of trust law income to which they are entitled, and to which has been paid or distributed to them.

3.6 That is, they may be subject to tax on amounts whish they will not receive, and are not entitled to actually receive.

3.7 This outcome seems to be contrary to the objectives of Division 6 of the 1936 Act as outlined by Emmett J in the Full Court of the Federal Court decision in *Bamford v Federal Commissioner of Taxation* (2009) 176 FCR 250 (discussed above).

(b) Implications if trust law income exceeds tax law income

3.8 However, where the net income of a trust estate for the purposes of s 95(1) of the 1936 Act is less than the trust law income, then a beneficiary who is "presently entitled" pursuant to s 97(1) of the 1936 Act will be required to include in their assessable income an amount which is less than the trust law income to which they will be entitled, and which will be paid to them.

3.9 As a result, an on the assumption that the beneficiaries are "presently entitled" to the whole of the trust law income, with the result that the whole of the "net income" of the

trust estate is included in their assessable income pursuant to s 97(1) of the 1936 Act, there can be no part of the net income to which ss 99 or 99A of the 1936 Act applies.

3.10 There is still a question as to whether, in these circumstances, the beneficiary must include the excess amount (i.e. the amount not included under s 97(1) of the 1936 Act) under some provision of the tax acts (e.g. CGT event E4 as contained in s 104-70 of the 1997 Act).

The quantum approach

3.11 The quantum approach (which is no longer good law) is based on the proposition that a beneficiary can only be presently entitled to such amount(s) of trust income as they actually receive.

3.12 Further, any part of the net income of the trust estate which exceeds the amount to which the beneficiary is presently entitled is not income to which the beneficiary is presently entitled to pursuant to s 97 of the 1936 Act, with the result that the trustee is subject to tax on it under s 99A of the 1936 Act (unless the Commissioner exercises it discretion to cause it to be subject to tax under s 99).

3.13 As with the proportionate approach, where the net income of the trust estate for s 95(1) of the 1936 Act purposes is less than the trust law income, such that the beneficiary receives an amount which is greater than the amount included in their assessable income, the question arises as to how the excess is to be taxed (if at all).

4. Bamford

4.1 Bamford was a much anticipated decision. In the view of some[1] the decision was a missed opportunity to settle an area of the trust law and tax law that has been crying out for correction: *Bamford* at [17] citing Hill J in *Davis v Federal Commissioner of Taxation* (1989) 86 ALR 195 at 230.

Background to Bamford

4.2 Mr and Mrs Bamford were beneficiaries of a discretionary trust known as the Bamford Trust (the "**Trust**"). The trustee of the Trust was P&D Bamford Enterprises Pty Ltd. Mr and Mrs Bamford were also the directors and employees of P&D Bamford Enterprises Pty Ltd.

[1] Slater QC *Taxation Trust Income After* Bamfor'ds *Case*, 26th National TIA Convention, 2-4 March 2011

4.3 During the 2000 income tax year, the Trust made a contribution to an offshore superannuation fund on behalf of Mr and Mrs Bamford. The contribution was sourced from borrowings by the corporate trustee, in its capacity as trustee of the Trust.

4.4 For the purposes of determining the "net income" of the Trust for the 2000 income tax year, the corporate trustee (in its capacity as trustee of the Trust) claimed a deduction for both the contribution made to the offshore superannuation fund, and the interest on the borrowed funds used to make the contribution. The total deduction claimed was $191,701.

4.5 After taking into account of the deductions, the "net income" of the Trust for that year was distributed to specified beneficiaries of the Trust. Included in the distribution were Mr and Mrs Bamford, who both had specified amounts distributed to them.

4.6 Specifically, for that income tax year (i.e. the 2000 income tax year), the trustee of the Trust allocated amounts to certain beneficiaries of the Trust, including a payment of $34,000 each to Mr and Mrs Bamford. However, the trustee of the Trust did not have sufficient funds to pay the full amount of $34,000, and instead paid them $33,872, being what the trustee of the Trust thought was the total remaining trust funds.

4.7 The amount initially distributed by the trustee of the Trust was $187,530.

4.8 In 2005, the Commissioner of Taxation applied the anti-avoidance provisions so as to disallow the deductions of the Trust (for the 2000 income tax year) for the superannuation contribution and the interest. As a result of the denial of the deductions, for the purposes of the 2000 income tax year the Trust's taxable income exceeded its accounting income.

4.9 The decision essentially dealt with two things:

4.9.1 whether the 'proportionate approach' applied in the event that tax law income exceeds accounting / trust income; and

4.9.2 whether the trust deed of the trust could characterise an amount of capital gains as income of the Trust.

Application of the proportionate view

4.10 As a result of the denial of the deduction, the Trust's taxable income increased by $191,000. The Commissioner issued amended income tax assessments to both Mr and Mrs Bamford. Pursuant to the assessments, the Commissioner contended that Mr and Mrs Bamford were liable to tax on the increased 'net income' of the Trust based on the proportionate share of the amount by which the taxable income of the trust exceeded the accounting income.

4.11 Indeed, the Commissioner sought to assess Mr and Mrs Bamford on an extra $34,624, on the basis that that amount represented the 'share' of the additional $191,000 as their share (i.e. 18%) of the previous amount (i.e. $187,530) actually distributed.

4.12 However, the taxpayers argued that they should only be taxed on the difference between the $33,872 which they actually received, and the specific amount of $34,000 which was originally allocated to them (i.e. an amount of $128 each).

4.13 The High Court rejected the taxpayer's argument, and in doing so applied the "proportionate approach".

4.14 The High Court took a two step approach in dealing with this issue:

4.14.1 First – the High Court held that the term "*… income of the trust estate …*" as contained in s 97(1) of the 1936 Act refers to distributable income, being income as determined by the trustee taking into account the terms of the trust (e.g. the trust deed) and appropriate accounting principles.

4.14.2 Secondly – after ascertaining the "share" of the distributable income to which a beneficiary is presently entitled, s 97(1) of the 1936 Act then requires that "*… that share of the net income of the trust estate …*" be ascertained, being the shares of the taxable income and not the distributable income.

4.15 Further, it was held that the inclusion within s 97(1) of the 1936 Act of the defined phrase "*… net income of the trust estate …*" and the undefined term "*… the income of …* [the] *… trust estate …*" indicated that these were intended to have different meanings. As a result, the term "*… the income of …* [the] *… trust estate* " had a different and defined meaning for taxation purposes.

4.16 The Court at [45] held that the analysis of Sundberg J in *Zeta Force Pty Ltd v Commissioner of Taxation* (1998) 84 FCR 70 at 74-75 should be applied:

> *The resolution of the second issue of construction is to be found in the analysis by Sundberg J in* Zeta Force Pty Ltd v Commissioner of Taxation *… . His Honour dealt with the first issue of construction to the same effect as that just explained, saying:*
>
> > *"The words 'income of the trust estate' in the opening part of s 97(1) refer to distributable income, that is to say income ascertained by the trustee according to appropriate accounting principles and the trust instrument. That the words have this meaning is confirmed by the use elsewhere in Div 6 of the contrasting expression 'net income of the trust estate'. The beneficiary's 'share' is his share of the distributable income."*
>
> *Sundberg J then continued:*
>
> > *"Having identified the share of the distributable income to which the beneficiary is presently entitled, s97(1) requires one to ascertain 'that share of the net income of the trust estate'. That share is included in the beneficiary's assessable income. The expression 'net income of the trust estate' in par (a)(i) has the meaning given it by s 95(1) – taxable income as opposed to distributable income. The words 'that share' in par (a)(i) refer*

back to the word 'share' in the expression 'a share of the income of the trust estate', and indicate that the same share is to be applied to an income amount calculated according to a different formula (taxable income as opposed to distributable income). Since the income amount may differ according to which formula is applied, the natural meaning to give to 'share' where it appears for the second time is 'proportion' rather than 'part' or 'portion'. When Parliament wanted to convey the latter meaning, as it did in ss 99 and 99A, it used the word 'part'.

The contrast between the expressions 'share of the income of the trust estate' and 'that share of the net income of the trust estate' shows that the draftsman has sought to relate the concept of present entitlement to distributable income, and not to taxable income, which is, after all, an artificial tax amount. Once the share of the distributable income to which the beneficiary is presently entitled is worked out, the notion of present entitlement has served its purpose, and the beneficiary is to be taxed on that share (or proportion) of the taxable income of the trust estate."

4.17 For the 2000 income year, the "net income" of the Trust included the amount of $191,701 which should not have been claimed as a deduction in the tax return of the Trust. As a result, the High Court held that the assessable income of Mr and Mrs Bamford should include a share of that amount, equivalent to the share they each received of the distributable income.

Whether the trust deed could re-characterise amounts

4.18 The trust deed of the Trust gave the trustee the discretion to determine whether a particular receipt should be treated as income or capital.

4.19 The trustee relied on this power to pass a resolution to distribute the first $60,000 of net income, "*… including …* [the] *…. capital gain …*" to Mr and Mrs Bamford in equal shares.

4.20 The Commissioner argued that the capital gain was not income of the Trust. Further, since there was no income, no beneficiary could be 'presently entitled' to the amount in question, the trustee of the Trust should be assessed at the special rates.

4.21 The High Court held that the term "income" as contained in s 99A of the 1936 Act should be interpreted as income of the trust estate, as understood in trust law.

4.22 As a result, the net capital gain of the Trust became the income of the Trust after the trustee exercised its discretion to characterise the capital gain as income of the Trust.

Outcome for Trust Distributions

4.23 There is no room for doubt that Bamford establishes that:

4.23.1 income of the trust estate identified in s 97(1) of 1936 Act is to be determined according to any directions set out in the Trust Deed;

4.23.2 the share of the net income attributable to a beneficiary is to be determined in the same proportions in which the beneficiary enjoys the present entitlement to the share of the income of the trust.

4.24 In this first regard, the Court made it clear that the general rules regarding apportionment between capital and income of receipts and outgoings was largely based on assumptions which could be displaced by the terms of the trust instrument: Bamford at [17]. The general law of trusts operates to give meaning to the term "the income of the trust estate".

4.25 The determination of present entitlement to a share of the income is a process of trust administration. The decision of the Full Court of the Federal Court in *C of T v Totledge Pty Ltd* (1982) 40 ALR 385 at 393 is quoted in support: Bamford at [39]. The High Court distinguished its own decision in *C of T v Australia and New Zealand Savings Bank Ltd* (1998) HCA 53 (Bamford at [39]) as not relevantly addressing the issue. Finally, the Court observed that the Commissioner's lack of consistency in wishing to exclude "statutory income" from "income of the trust estate" did not assist his argument that "income" means "income according to ordinary concepts": Bamford at [41].

4.26 On the meaning of the term "share of the net income" the High Court adopted the proportionate approach advocated by Sunberg J in *Zeta Force* (discussed above).

4.27 What does this translate into for trustees making decisions in respect of trust distributions for the 2010 income year?

4.28 There are a number of relevant observations to be made.

4.29 First, if the Trust Deed provides a formula for determining the income of the trust then that formula will determine the entitlement of the beneficiaries to income. If, for example, the Deed contains words to the following effect:

> *"The net income of the trust is an amount equal to the amount determined in accordance with subsection 95(1) of the* Income Tax Assessment Act 1936 *but reduced by any amount which would otherwise be included by application of Division 207 of the* Income Tax Assessment Act 1997*".*

4.30 Throughout this paper "subsection 95(1) terms" means an amount adjusted for the franking credit gross up. The issue of grossing up is considered below in the context of using the full tax exemption including the franking rebate available to children.

4.31 Leaving aside the elimination of any gross up for franking credits (which itself is affected by the Streaming Amendments as discussed below) the amount of net income for trust law purposes

will equal the tax law income. The two will coincide so that there should, in the ordinary course, be no amount assessable to the trustee under s 99A of the 1936 Act.

4.32 Secondly, if the Trust Deed is silent then "ordinary income" principles apply. Just what they are is difficult to say. The ATO has expressed the view that income of a trust is income according to ordinary principles. This is not the same thing as accounting income determined in accordance with accounting principles. It requires a dissection of receipts into:

4.32.1 income according to ordinary principles;

4.32.2 income which is not ordinary income;

4.32.3 capital receipts.

4.33 Following that dissection, the expenses must be apportioned accordingly.

4.34 This is, of course, all too much. Many trust deeds will have a clause like that in Bamford which allows the trustee to determine whether a receipt is capital or income. Others will have very broad powers allowing the trustee to determine the basis on which income of the trust is to be worked out.

4.35 If these powers exist they should be used to avoid uncertainty brought about by the "ordinary income" approach. If they do not exist then the deed should be to give the trustee such a power. Whether such an amendment will amount to a resettlement, which might have adverse capital gains tax (and stamp duty) consequences, is discussed at **paragraphs xx** below.

4.36 Thirdly, because the proportionate approach has prevailed, a strict application of that rule will mean that great care needs to be taken when seeking to direct a specific amount of tax law net income to a particular beneficiary with absolute certainty e.g. the maximum amount to a child which escapes the punitive rates under Division 6AA of the 1936 Act. This issue is illustrated in the Examples which follow.

4.37 Fourthly, the High Court decision says nothing about streaming of trust income. The matter was not in issue. The uncertainty about streaming of income according to its character remained unabated, until the Streaming Amendments.

4.38 Finally, the ATO has done away with the benevolent "capital beneficiary" approach set out in Practice Statement PSLA 2005/1 (GA) on and from 13 October 2010.

Examples

4.39 The best way to illustrate these points is by way of example. In the examples which follow the following facts apply in relation to the A Family Trust for the income year ended 30 June 2010:

Receipts:

rent	$50,000
net capital gain	$100,000

Expenses:

rental expenses	$10,000
interest	$20,000

4.40 The interest relates to the rental property only. The discountable capital gain was made on the sale of shares in a listed company. The intended beneficiaries are Mr and Mrs A and their two children both under 18.

4.41 Because of the low income rebate the following no-tax thresholds apply to minors:

Income Year end 30 June	**$**
2010	3,000
2011	3,333

4.42 If the income constitutes fully franked dividends the cash payment thresholds and grossed up taxable income amounts are:

Income Year end 30 June	**$ cash**	**$ taxable income**
2010	6,300	9,000
2011	7,000	10,000

4.43 These figures have considerable significance for trustees seeking to hit the no tax "sweet spot" for a distribution to a child.

(a) Subsection 95(1) terms apply – no "balance approach"

4.44 The taxable capital gain is $50,000. Accordingly, the distributable trust income is $70,000.

4.45 For 2010 a minor may be distributed $3,000 with no tax liability if entitled to the low income rebate (see comments above).

4.46 The trust distribution minutes might give effect to the following:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000

70,000

4.47 The tax law results will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.48 The cash in the trust will include the $50,000 covered by the 50% general CGT discount. This is not income and can be dealt with as capital. As this is a discretionary trust it can be distributed without tax consequences.

(b) Ordinary income applies – no "balance approach"

4.49 In this instance the trust distribution minutes will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	7,000
Mr A	7,000
	20,000

4.50 The tax law results will be:

	$
Child 1	$3{,}000 + {}^{3,000}/_{20,000} \times \$50{,}000$
Child 2	$3{,}000 + {}^{3,000}/_{20,000} \times \$50{,}000$
Mrs A	$7{,}000 + {}^{7,000}/_{20,000} \times \$50{,}000$
Mr A	$7{,}000 + {}^{7,000}/_{20,000} \times \$50{,}000$

4.51 The final results:

	$
Child 1	10,500
Child 2	10,500
Mrs A	24,500

Mr A	24,500
	70,000

4.52 This is a strict application of the proportionate approach.

4.53 Each of the children will pay tax on $7,500 at the Division 6AA punitive rates of 45%. This is not a good result.

(c) Subsection 95(1) applies – "balance approach" used

4.54 Trust minutes:

	$
Child 1	3,000
Child 2	3,000
Mrs A	half of the balance
Mr A	half of the balance

4.55 Trust income entitlements:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.56 The tax law result:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.57 This is the same outcome as where no "balance approach" is applied – but see below for the effect of a tax adjustment.

(d) Ordinary income applies – "balance approach" used

4.58 Trust minutes

	$
Child 1	3,000
Child 2	3,000
Mrs A	half of the balance
Mr A	half of the balance

4.59 Trust income created will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	7,000
Mr A	7,000
	20,000

4.60 The tax law results will be:

	$
Child 1	$3{,}000 + {}^{3,000}/_{20,000} \times \$50{,}000$
Child 2	$3{,}000 + {}^{3,000}/_{20,000} \times \$50{,}000$
Mrs A	$7{,}000 + {}^{7,000}/_{20,000} \times \$50{,}000$
Mr A	$7{,}000 + {}^{7,000}/_{20,000} \times \$50{,}000$

4.61 The final results:

	$
Child 1	10,500
Child 2	10,500
Mrs A	24,500
Mr A	24,500
	70,000

4.62 Again there is no difference. However, the "balance approach" is more realistic because it is unlikely that the trust income or tax law income will be known as at any 30 June. In reality these figures are not known until the accounts are drawn later in the calendar year.

(e) Tax Law Adjustments

4.63 It is often important to anticipate an adjustment to the trust's tax law income especially where there is something contentions going on.

4.64 As has been seen the tax law result will follow on a proportionate basis the entitlements to income created under the Deed. To test the outcome it is assumed in the above examples that the trustee failed to recognise $10,000 of rental income (say the trustee at first considered that the income was to be deferred until the 2011 income year) but was in fact wrong about this.

4.65 How do the various approaches deal with such an adjustment?

Example (a) – subsection 95(1) applies (but no "balance approach")

4.66 The trust law entitlements and tax law results were the same:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.67 The tax law adjustment will increase both the trust law entitlement and the tax law income by $10,000. The Trustee has not dealt with this $10,000 and, without an operative default beneficiary clause, it will be assessed to the Trustee under section 99A of the 1936 Act.

4.68 The trust law entitlements and tax law result will be:

	$
Child 1	3000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
Trustee	10,000
	80,000

4.69 However, if there is no streaming of the capital gain (with the effect that all beneficiaries are entitled to a proportionate part of the capital gain) that part of the capital gain reflected in the income to which no beneficiary is presently entitled will be grossed up for the loss of the 50% general CGT discount. Five eighths of the $10,000 adjustment assessed to the Trustee is capital gain. As a result the share of the net income assessable to the Trustee will be increased by $6,250.

4.70 The final result will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
Trustee	16,250
	86,250

4.71 This is a costly outcome.

Example (c) – subsection 95(1) but using a "balance approach".

4.72 The trust law entitlement and tax law result were the same.

	$
Child 1	3,000
Child 2	3,000
Mrs A	half of the balance
Mr A	half of the balance

4.73 The unadjusted result was:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.74 The adjusted trust law entitlement and tax law result will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000 + 5,000
Mr A	32,000 +5,000
	80,000

4.75 The "balance approach" together with adoption of s 95(1) terms directs all of the tax law result from an adjustment made by the ATO to the balance beneficiaries.

4.76 If the balance distribution has been used Mr and Mrs A will "enjoy" a further $5,000 of income entitlement (it now having been correctly determined) and a further $5,000 of tax law net income each. No amount will be assessed to the trustee.

4.77 There is an argument that the beneficiaries have not become presently entitled to the amount of the adjustment to the trust law net income as it was not ascertained at the end of the income year. In the writer's opinion the trust law net income was always the amount as correctly adjusted by the ATO. There was never any uncertainty about it. It is simply the case that the trustee and ATO had not properly determined the correct quantum of income.

4.78 In practical terms how have the Courts looked at the "balance approach"? It has not come up that often.

4.79 The decision of Cooper J in *BRK (Bris) Pty Ltd v C of T* [2001] FCA 164 might at first blush give cause for concern. There the Court considered the operation of the default beneficiary clause in the Trust Deed. The distributions had been:

1993 income year:

"Hendon Unit Trust 100%

and Resolved that should the Commissioner of Taxation disallow any amount as a deduction or include any amount in the assessable income of the Trust, such amount or amounts are to be deemed distributed on 30th June 1993 in the same proportions as listed above to the beneficiaries listed above".

1994 income year:

(a) The sum of $304,021.72 to Westside Commercial Centre Pty Ltd as trustee of the Hendon Unit Trust for its absolute benefit.

(b) The following sums to the following beneficiaries for their absolute respective benefits: NIL

(c) The Balance to Jessica Wagner and Bill Wagner equally between them for their absolute benefit.

1995 income year:

Hendon Unit Trust	*First $220,000*
Northbourne Trust	*Next $100,000*

Wilhelm J Wagner and Jessica O Wagner	*Remainder of balance equally*

4.80 The same "variation of income" clause as in 1993 applied in this year.

4.81 It would appear that the Trust Deed did not adopt subsection 95(1) terms and that income was ordinary income.

4.82 It was found that the Hendon Unit Trust was not an object of the Trust and the distribution of income to it failed. The default beneficiaries clause distributed income in default of appointment to the beneficiaries described in the Schedule to the Deed as tenants in common. This was the usual wide class of family objects.

4.83 The Court concluded that the default beneficiary clause did not operate as at 30 June because the trustee had a reasonable time after the end of the income year in which to decide to distributed or accumulate.

4.84 The question arose as to whether the balance clause in the 1994 and 1995 determinations operated to take the amounts which the Trustee had attempted to distribute to the Hendon Unit Trust to Mr and Mrs Wagner. It was concluded that this was not the effect of the distribution minute and, as a result, the Trustee was assessable under section 99A.

4.85 At [40] Cooper J concluded:

> *"In my judgment the submission is misconceived. In the 1994 income year the clear intention of the applicant was to appoint to Mr and Mrs Wagner only so much of the Trust income, if any, as exceeded $304,021.72 in addition to any income in excess of that amount in the event that the appointment to WCC should fail. The position is no different in respect of the 1995 year. The trustee purported to appoint discrete amounts of income to the Hendon Unit Trust as to the first $220,000 and to the Northbourne Trust as the next $100,000. Finally, as to any remainder after the application of the first $320,000 of income, that remainder was to be appointed to Mr and Mrs Wagner; they did not as a matter of construction or intention on the part of the trustee, take by default all of the income in the event of failure of the other two appointments."*

4.86 Rather than being a cause for concern about the "balance approach" the decision of Cooper J on this point supports its operation. The specific quantum entitlements fix the income (and tax where s 95(1) terms apply) at the amount specified in the Trustee's determination. If the gift fails it does not flow to the balance beneficiary but to the default beneficiary or, in the alternative, there is no such entitlement created, giving rise to a s 99A assessment to the trustee.

4.87 Further comfort can be obtained from observations made in *C of T v Ramsden* [2005] FCAFC 39. In that case the Court was concerned with the issue whether a beneficiary had effectively renounced a distribution of income.

4.88 The distribution minutes for the 1996 income year provided:

"Steve Hart Family Holdings No.2	*$17,295*
Steve Hart Family Holdings No.3	*$6,639*
Unlimited Aerobatic Discretionary Trust	*$34,810*
The Adcock Practice Trust	*$429,000*
Troy B Hart	*$4,750*
Steven I Hart	*The Balance"*

4.89 It was agreed that the Adcock Practice Trust did not qualify as a beneficiary. The default beneficiary clause provided for income which had not been appointed prior to year end to be held for Steven Hart and his three children as tenants in common. The ATO assessed each of the default beneficiaries to one quarter of the amount which had failed to be appointed to the Adcock Practice Trust.

4.90 The argument was pressed before the primary judge that the income should pass by way of the balance distribution to Steven Hart: Ramsden at [38] to [41]. Justice Spender's rejection of this argument was confirmed by the Full Court. It was observed at [2005] FCAFC 39 at [72]:

> *"We agree with this construction. 'The Balance' does not include the amounts which precede "The Balance" in the resolution of 30 June 1996.*
>
> *'The Balance' is the Income of the Trust for the year ended 30 June 1996 other than the amounts which precede it in the resolution in question, whether effectively appointed or not".*[2]

4.91 This observation supports the "balance approach" taken in this paper where there have been effective distributions. Note, however, that it will not work where a distribution is ineffective. In such a case the adjustment will be assessed to the default beneficiary, if there is one, or to the trustee.

Example (d) – Ordinary Income with balance approach applying

4.92 The trust law entitlements were:

	$
Child 1	3,000

[2] [2005] FCAFC 39 at para. 72.

Child 2	3,000
Mrs A	half of the balance
Mr A	half of the balance

4.93 Trust income entitlements:

	$
Child 1	3,000
Child 2	3,000
Mrs A	7,000
Mr A	7,000
	20,000

4.94 The tax law result was:

	$
Child 1	10,500
Child 2	10,500
Mrs A	24,500
Mr A	24,500
	70,000

4.95 When the tax law income is adjusted by $10,000 there is no change to the trust law result. The tax law result will be:

	$
Child 1	$10,500 + {}^{10,500}/_{70,000} \times \$10,000$
Child 2	$10,500 + {}^{10,500}/_{70,000} \times \$10,000$
Mrs A	$24,500 + {}^{24,500}/_{70,000} \times \$10,000$
Mr A	$24,500 + {}^{24,500}/_{70,000} \times \$10,000$

4.96 The final result will be:

	$
Child 1	12,000
Child 2	12,000
Mrs A	28,000
Mr A	28,000

	80,000

4.97 The result has only become worse from a Division 6AA income perspective.

Will a "default beneficiary" clause in the Deed assist?

4.98 An income default beneficiary clause would be expressed something like:

> *"If the Trustee has not determined to distribute all of the net income of the Trust by the end of the Income Year the Income Default Beneficiary will be absolutely entitled to that part of the net income which has not been distributed."*

4.99 The term "Income Default Beneficiary" will be appropriately defined to identify individuals or companies.

4.100 In Example (a) – subsection 95(1) terms but no "balance approach" – a default beneficiary clause would have deflected the tax adjustment from the trustee to the default beneficiary.

4.101 In Example (b) – ordinary income but no "balance approach" – the default beneficiary clause would have no effective operation as all of the trust law/tax law income has been accounted for.

4.102 The trust entitlements were:

	$
Child 1	3,000
Child 2	3,000
Mrs A	7,000
Mr A	7,000
	20,000

4.103 The tax law result was:

	$
Child 1	10,500
Child 2	10,500
Mrs A	24,500
Mr A	24,500
	70,000

4.104 If the tax law income is increased by $10,000 the trust law income does not alter. The tax law adjustment is apportioned according to the trust law income apportionments, as follows:

	$
Child 1	10,500 + $^{3,000}/_{20,000}$ x 10,000
Child 2	10,500 + $^{3,000}/_{20,000}$ x 10,000
Mrs A	24,500 + $^{7,000}/_{20,000}$ x 10,000
Mr A	24,500 + $^{7,000}/_{20,000}$ x 10,000[3]
	70,000

4.105 The final tax results will be:

	$
Child 1	12,000
Child 2	12,000
Mrs A	28,000
Mr A	28,000
	80,000

4.106 In Example (c) – subsection 95(1) terms and a "balance approach" – the default beneficiary clause has no role to play because the adjustment will always be directed to the balance beneficiary.

4.107 In Example (d) – ordinary income and "balance approach" – the default beneficiary clause has no need to operate because the tax adjustment will simply be apportioned in accordance with the trust law entitlements which don't change.

Summary re Tax Adjustments

Trust Accounting Basis	Tax Law Income	Trust Income	Adjustment to (if no default beneficiary)	Adjustment to (if there is a default beneficiary)
subsection 95(1) – no "balance approach"	+ $100	+ $100	Trustee	Default Beneficiary
subsection 95(1) – "balance approach"	+ $100	+ $100	Balance Beneficiaries	Balance Beneficiaries
ordinary income – no "balance approach"	+ $100	no change	All Beneficiaries	All Beneficiaries
ordinary income – "balance approach"	+ $100	no change	All Beneficiaries	All Beneficiaries

[3] The proportions remain the same whether the trust law or tax law results are used.

Guidance from Bamford

4.108 As the High Court observed in Bamford at [17]:

> *"… both sides in argument on the present appeals accepted that whichever of the competing constructions of Div 6 were accepted examples could readily be given of apparent unfairness in the resulting administration of the legislation"*

4.109 In reaching the conclusion that the terms of the Trust Deed determine the trust income to which a beneficiary may be made entitled the High Court has gone very far towards resolving most of the problems and uncertainties which confronted practitioners and the trustees and beneficiaries they advise. With a good understanding of the terms of the Trust Deed as they effect trust distributions most distribution problems can be addressed.

4.110 As has been demonstrated in the above worked examples adopting a s 95(1) terms plus "balance approach" achieves the following:

4.110.1 the quantum of tax distribution to children can be locked in.

4.110.2 any "normal" tax adjustment will flow to the balance beneficiaries.

4.110.3 if used in conjunction with a default beneficiary clause ineffective distributions can also be dealt with.

4.111 The subsection 95(1) but without a "balance approach" can lead to:

4.111.1 an assessment of the tax adjustments to the trustee under section 99A;

4.111.2 clawback of any general CGT discount.

4.112 This can be addressed by using a default beneficiary (of course the default beneficiary should not be a company where the general CGT discount is involved).

4.113 The balance approach together with a considered default beneficiary is to be preferred as the outcome is more predictable.

4.114 The ordinary income approach is problematic because it is:

4.114.1 too difficult to calculate what is net ordinary income;

4.114.2 and tax law adjustments will be spread across all beneficiaries (as there is no adjustment to the net income).

5. Div 7A Amendments

5.1 Division 7A of Part III of the 1936 Act deals with accessing wealth in private companies without accounting for the tax that would otherwise be payable on the value accessed. It focuses on three means of accessing wealth in private companies – payments from a private company, loans from a private company or the forgiveness of a debt by a private company to an associate of that company.

5.2 In 2010 there were two broad changes to the Division 7A interacts with trusts:

5.2.1 The Div 7A Amendments; and

5.2.2 The Commissioner's position in *Taxation Ruling 2010/3* and *Practice Statement Law Administration* 2010/4.

5.3 The changes to Division 7A include the insertion of an introductory note to Division 7A stating:

> An amount may also be included in the assessable income of a shareholder or shareholder's associate if:
>
> (a) a company has an unpaid present entitlement to income of a trust; and
>
> (b) the trustee makes a payment or loan to, or forgives a debt of, the shareholder or associate.
>
> (See Subdivisions EA and EB.)

5.4 This note is of interest as it strongly suggests that Subdivision EA is a 'code' which is intended to capture arrangements where there is an unpaid present entitlement subsisting between a trust and a corporate beneficiary and there is then a loan, payment or forgiveness that occurs between the trustee and a shareholder or an associate of a shareholder in the corporate beneficiary.

5.5 This should be contrasted with the position in the ATO *Taxation Ruling* 2010/3 where the ATO assert that subdivision EA has much more limited effect, where they generally restrict its operation to the situation where there is a sub-trust in existence between a trustee and a corporate beneficiary and there is then loan, payment or forgiveness involving a shareholder or an associate of a shareholder and the trustee of the sub-trust.

5.6 In the 31 March 2010 NTLG meeting the professional bodies questioned the ATO as to whether the introduction of this provision into Division 7A cast doubt on the position in their draft ruling. The meeting agenda includes the following discussion:

> The ATO does not see a conflict between the legislation of provisions dealing with unpaid present entitlements and the position set out in Draft Ruling TR 2009/D8.

This is because, contrary to the premise of the question, under Draft Ruling TR 2009/D8 unpaid present entitlements will retain that status for Division 7A purposes in many situations, including where:

- the amount representing the UPE is physically held on sub-trust for the sole benefit of the private company beneficiary;
- the amount representing the UPE is being used by the trustee but all benefits from this use are held for the sole benefit of the private company; or
- the private company beneficiary is not aware and cannot be taken to be aware that the funds representing its UPE are being used for the potential benefit of any or all discretionary objects of the trust (rather than being physically set aside or used for its sole benefit).

The ATO has appropriately consulted with Treasury prior to and during the drafting of TR 2009/D8.

Provisions within Division 7A dealing with unpaid present entitlements will continue to have their intended application and there is no inconsistency between the Exposure Draft legislation and the draft Ruling.

Use of assets

5.7 As was announced in the 2009/10 Federal Budget the use of assets owned by private companies, or owned by trusts where there is a present entitlement owing to a private company may be subject to tax after 1 July 2009.

5.8 The way in which the use of assets will become subject to tax is through the amendment of the definition of the term 'payment' in Division 7A so that it extends to the provision of an asset (other than a transfer of property) for use by an entity. Consistent with the present operation of Division 7A the provision of the asset will only result in Division 7A consequences where the asset is provided to a shareholder or associate of a shareholder.

5.9 For the purposes of Division 7A the payment will occur when the use of the asset occurs.

5.10 A payment will also arise however where the asset is not used, but is available for use. The examples in the EM are illustrative of when it will be the right to use the asset, and not its use, that is subject to the Division 7A rules.

> ***Example (right to use from EM)***
> ***Brian is a shareholder of a private company that owns a luxury yacht. He does not have a formal agreement with the company in relation to the yacht, however, he takes the yacht out every second weekend.***
>
> ***Brian keeps the yacht at the company's business premises, but takes the key home. Brian stores several personal items on the yacht.***
>
> ***Brian's fortnightly use of the yacht is a payment under Division 7A. The availability of the yacht for Brian's use is also subject to Division 7A because the yacht is not readily available for use by the company. The company would need to arrange with Brian to***

get the key and for the removal of Brian's personal items before using the yacht. That is, the asset is available for Brian's use to the exclusion of the company.

Example (use from EM)
Marina is a shareholder of a private company that owns a city apartment. The apartment is generally available for rent. However, Marina asks the company not to rent the apartment out for a week so that she and her family can use the apartment over a long weekend. Marina's use of the apartment is a payment for the purposes of section 109CA.

5.11 An issue that arose on consultation over the draft legislation giving effect to these changes was whether the mere availability of assets to a shareholder or associate would result in the shareholder or associate being treated as having the asset available for their use. The EM again includes an example where there a payment is not taken to arise where an asset is available as a result of a general entitlement to use an asset without actual use of the asset.

Example (mere entitlement from EM)
Peter is a shareholder of a private company that owns five cars for company use. Shareholders and their associates have general permission to use the cars on weekends if they are not being used for company business. Peter regularly takes one of the cars home.

Peter's use of the car that he takes home will be subject to Division 7A. This will include driving the car (actual use) and the availability of the car for his use to the exclusion of the company, such as when it is parked at home, or at a restaurant that Peter is visiting.

Although Peter may have general permission to use all five of the cars, he does not use all of them for the purposes of Division 7A. The four cars that Peter leaves at the company premises are available for the company to loan to another shareholder, employee, customer, or other party. That is, these cars are not available to Peter to the exclusion of the company.

5.12 The EM also includes examples of where an asset is available to more than one shareholder or associate and it is necessary to determine who is taxed. The EM suggests and apportionment of the taxable value to the person who is the real recipient of the benefit. One example sets out that a minor that benefits should not be taken to receive a Division 7A payment, where another sets out that incidental use by a spouse of a vehicle provided to a shareholder would not result in the spouse being taxed on the benefit provided.

5.13 In valuing the payment taken to be made it will be the amount that would have been paid for the use of the asset in an arm's length dealing less any consideration paid that will be determined to be the payment for Division 7A purposes.

5.14 There are a number of exceptions from the payment provisions applying, including one not previously announced dealing with residential property:

5.14.1 Minor benefits – if the provision of the asset would have been a minor benefit under section 58P of the FBTAA had it been provided to an employee then the benefit will be disregarded for Division 7A purposes

5.14.2 Otherwise deductible payments – if a once off deduction would have been available to the shareholder or their associate in connection with the use of the asset then there will be no benefit to be taken into account for Division 7A purposes.

5.14.3 Dwellings – the use of a dwelling can be exempt where the following conditions are satisfied:

5.14.3.1 the entity or their associate is carrying on a business;

5.14.3.2 the entity or their associate uses or is granted or has a lease, licence or other right to use land, water or a building for the purpose of carrying on the business; and

5.14.3.3 the provision of the dwelling to the entity is connected with that use or with that lease, licence or other right to use the land, water or building to carry on the business.

5.14.4 Main residences – the provision of a dwelling that is a person's main residence does not result in a Division 7A payment where:

5.14.4.1 The provider of the dwelling is a private company;

5.14.4.2 The private company acquired the dwelling before 1 July 2009; and

5.14.4.3 The private company would pass COT from the time that the dwelling was acquired until the end of the time that a payment could be taken to be made under Division 7A.

5.14.5 Vacant land – if the exception for a dwelling or a main residence applies, it will extend to adjacent land in the same way as occurs in the main residence exemption.

Corporate limited partnerships

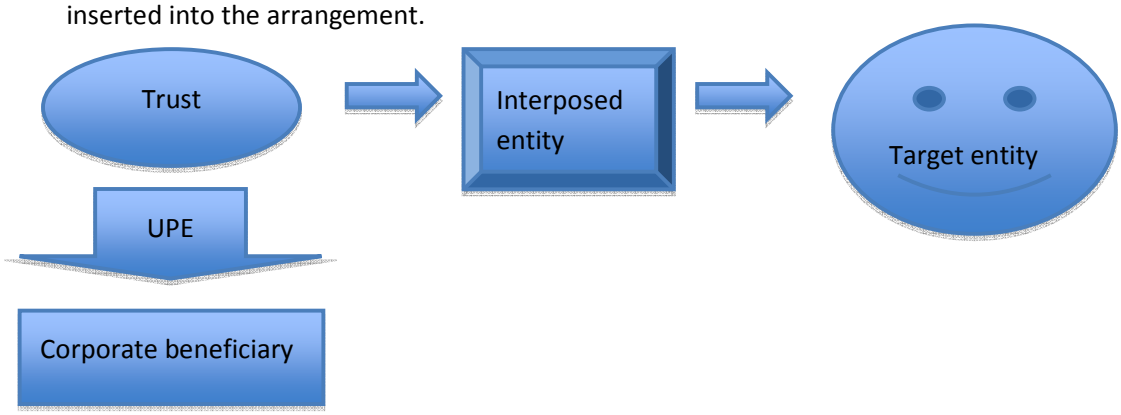
5.15 Closely held corporate limited partnerships (limited liability partnerships) will also now be subject to Division 7A. A corporate limited partnership will be closely held where it has fewer than 50 members or where an entity has, directly or indirectly, for the entity's own benefit, an entitlement to 75% or more of the income and capital of the partnership.

Interposed entities

5.16 The Div 7A Amendments fix two drafting issues in relation to the use of interposed entities.

5.17 The Division 7A legislation as originally drafted allowed for a payment by a private company through an interposed entity to be treated as a payment for Division 7A purposes.

5.18 The legislation did not however on a plain reading, allow for a trust where there was an unpaid present entitlement, to be deemed to have made a payment where an interposed entity was inserted into the arrangement.



5.19 A payment from the trust through an interposed entity to a target entity will now be caught by Division 7A if a reasonable person would consider that a loan or payment made to the interposed entity was made to enable a loan or payment to be made by the interposed entity to the target entity.

5.20 Consistent with the current operation of Subdivision EA however, a payment through to the target entity will only result in a Division 7A deemed dividend if it is referable to a reduction in a present entitlement that is in itself attributable to an unrealised gain in the trust.

5.21 The Div 7A Amendments also ensures that where an unpaid present entitlement is owed to a company by a trust, but the loan, payment or forgiveness that occurs does not involve the trust that owes the unpaid present entitlement, that Subdivision EA still has effect.

5.22 Subdivision EA will apply to treat a loan or payment from a trust as being a Division 7A loan or payment to the extent that the loan or payment is referable to an unpaid present entitlement owed to a private company where that amount has not already resulted in a Division 7A loan or payment.

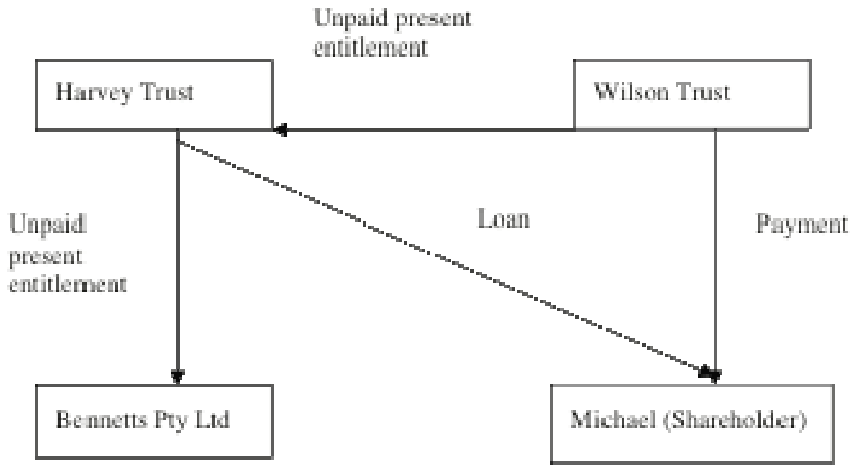
Example (interposed trust from EM)
Michael is a shareholder of Bennetts Pty Ltd and Bennetts Pty Ltd is a beneficiary of Harvey Trust. In the 2009-10 income year, Michael receives a payment from the trustee of the Wilson Trust, which is attributable to an unrealised gain. He receives this payment

because of his shareholding in Bennetts Pty Ltd. Michael also receives a $2,000 non-compliant Division 7A loan from the Harvey Trust.

Bennetts Pty Ltd is not presently entitled to an amount from the net income of the Wilson Trust. However, Bennetts Pty Ltd is entitled to $10,000 from the net income of the Harvey Trust (the first interposed trust) and Harvey Trust is presently entitled to $10,000 from the net income of the Wilson Trust. These amounts remain unpaid.

The loan made by the Harvey Trust to Michael will be included in Michael's assessable income under ordinary operation of subsection 109XA(2).

Bennetts Pty Ltd is taken to be presently entitled to $8,000 from the Wilson Trust, which is the unpaid present entitlement of $10,000 from the Harvey Trust, reduced by the $2,000 loan amount that is included in Michael's assessable income under another provision of Subdivision EA.



Loan back arrangements

5.23 Subdivision EA as currently drafted only captures payment arrangements where the payment is a reduction of a present entitlement that is referrable to an unrealised gain.

5.24 To circumvent these rules, apparently it had been suggested that the following arrangement could be entered into:

5.24.1 An unpaid present entitlement exists to a private company, say of $100,000.

5.24.2 A payment is made by the trustee of the trust to a beneficiary of an amount far in excess of the UPE, for example $1 million.

5.24.3 The amount in excess of the UPE is then loaned back to the trustee, being $900,000.

5.24.4 Thus, the beneficiary now has a credit loan of $900,000.

5.24.5 In future years the trustee appoints income to the company and uses the funds to repay the credit loan.

5.25 The need for there to be a payment referrable to a reduction of an unrealised gain will be removed where the payment made to a beneficiary is in reduction of a loan made on or after 1 July 2009 where a reasonable person would conclude that the trustee obtained the loan in order to make the payment.

Amendment to distributable surplus definition

5.26 The definition of distributable surplus will be amended so that amounts that have been deemed to be dividends as a result of the operation of Subdivision EA will be removed from the distributable surplus (by being correctly included as non-commercial loans).

Forgiveness of 109XB loans

5.27 There is a drafting problem that will be rectified so that the forgiveness of a loan by a trustee that has already been deemed to be a dividend will not result in a subsequent dividend. The law already applies in this way to the forgiveness of a debt owed to a private company by a shareholder that has already been deemed to receive a dividend under Division 7A.

Dividend set-off

5.28 Another drafting problem dealing with dividend set-offs will also be rectified.

5.29 At present, where a private company makes a loan that is deemed to be a dividend and later pays an unfranked dividend that is set off against that loan the later dividend is not included in assessable income.

5.30 The ability to disregard the later dividend does not apply where the loan was made by the trustee of a trust and where the deemed dividend arose under section 109XB.

5.31 The ability to disregard a later unfranked dividend offset against a loan from a trustee is being introduced.

Setting off employment entitlements

5.32 Another unusual aspect of the interaction of Division 7A generally and Subdivision EA has been that employment related payments that are offset against loans by trustees do not count as repayments if there is a borrowing of a similar or greater amount to the amount repaid. This is in contrast to setting off such a payment against a loan by a company where the repayment is taken into account even if there is a further borrowing.

5.33 This anomaly is to be rectified.

Borrowing to repay

5.34 Under the previous law a repayment is disregarded where the repayment is made where a reasonable person would conclude the repayment was made in order to borrow a similar or greater amount. This prevents a person from borrowing funds during a financial year, repaying on 30 June, and then reborrowing the amount on 1 July.

5.35 While the law has operated in this way (with some exceptions for repayments that occur by way of offsetting assessable amounts such as the wages noted above) it arguably has not operated where, instead of repaying to borrow, a person borrows to repay. This was be remedied so that a borrowing to repay will also activate section 109R.

> ***Example (from EM)***
> ***Alicia obtains a loan of $10,000 from Cleary Pty Ltd. Alicia has until the lodgment day to repay the loan. Two weeks before the lodgment day Alicia obtains a further $10,000 from Cleary Pty Ltd. She then repays the original $10,000 loan a week before the lodgment day.***
>
> ***The repayment of the original $10,000 loan is not a repayment for the purposes of section 109D, because Alicia has borrowed a similar amount from Cleary Pty Ltd and in this case a reasonable person would conclude that the loan was obtained in order to make the repayment of the original $10,000.***
>
> ***The original $10,000 loan is treated as a deemed dividend subject to the distributable surplus of the private company.***

Adding back payments for Division 7A purposes

6. Streaming

6.1 The paper will no consider the importance of, and ability to, stream as it stood before the Streaming Amendments. Then it will consider the Streaming Amendments.

Pre-Streaming Amendments

6.2 As can be seen from the illustrations above the ability to stream income according to its character is very important. This is particularly the case for franked dividends and capital gains but there are other forms of income with tax characteristics that may also be important e.g. income from a foreign source, income which has been subject to TFN withholding tax.

6.3 The decisions in Bamford tell us nothing about streaming income for tax purposes.

6.4 Most modern trust deeds will give the trustee power to distinguish between classes of income and to characterise a particular amount of income as having been derived from a particular source. The Deed should also allow the trustee to allocate expenses to the different classes of income.

6.5 The law regarding streaming after the decision in *CPT Custodian Pty Ltd v Commissioner of State Revenue [2005] HCA 53* ("**CPT Custodian**") was quite uncertain. The decision of the High Court in *Charles v C of T [1954] HCA 16* ("**Charles**") has always been the centre of gravity of the character flow through approach. The decision in Charles was heavily criticised by the Court in CPT Custodian. The question is whether that criticism went to the maintenance of character or is restricted to the characterisation of the interest in the trust fund by looking through to the underlying assets.

6.6 The decision of the High Court in CPT Custodian, in the writers' views, stands for the proposition that a beneficiary has an equitable interest in the residue of the trust fund after the Trustee's indemnity has been satisfied. This residue is characterless, whether it be income or capital, as the trustee may at any time satisfy its right to be indemnified from the receipts (which themselves have character).

6.7 Notwithstanding these problems the ATO has consistently taken the view that the character of the income in the hands of the beneficiary is taken from the character of the receipts of the Trustee[4] even after taking into account the decision in *CPT Custodian*[5].

6.8 In the non-binding ruling IT2328 (now withdrawn) it was observed:

> *"For income tax purposes where a beneficiary in a trust estate is presently entitled to the net income or a share of the net income of the trust estate, that income as a general principle has the same character in the hands of the beneficiary as it had in the hands of the trustee."*

6.9 The most significant streaming issues concern capital gains and dividends. In the case of capital gains Division 115 of Part 3-1 of the 1997 Act proceeds on an implication that income entitlements will take on at least some part of the character of the capital gains derived by the trustee. There is no clear legislative follow through. The guidance found in Sesction 115-200 of the 1997 Act establishes the implied maintenance of character:

> *"This Subdivision sets out rules for dealing with the net income of a trust that has a net capital gain. The rules treat parts of the net income attributable to the trust's net capital gain as capital gains made by the beneficiary entitled to those parts."*

[4] see in particular ATO ID 2008/51 dealing with Division 13.3A of the SIS Regulations.

[5] see Taxation Ruling STR 92/13, IT2328, IT2512, IT2004 (withdrawn) and ATO ID 2007/108 (which is concerned with foreign sourced income and in respect of which subsection 6B(2A) of the 1936 Act also comes into consideration).

6.10 Subsection 115-215(1) is the nub of the provisions:

> *"The purpose of this section is to ensure that appropriate amounts of the trust estate's net income attributable to the trust estate's capital gains are treated as a beneficiary's capital gains when assessing the beneficiary, so:*
>
> *(a) the beneficiary can apply capital losses against gains; and*
>
> *(b) the beneficiary can apply the appropriate discount percentage (if any) to gains."*

6.11 The process is described as attribution rather than maintenance of source character. This may be the necessary distinction to make the rules work. There is, however, no guidance about how the attribution is to be carried out.

6.12 What is clear is that if there is no trust income to which the beneficiary is presently entitled there can be no attribution. This is a major issue where there is no trading income but there are capital gains in the Trust. Use of s 95(1) terms to describe income overcomes this problem and makes the case for attribution much clearer. The capital gain (or at least 50% of it) will be included in the income. The connection for Subdivision 115-C purposes is very clear.

6.13 The ATO has had to resort to the artificiality of the "capital beneficiary approach" in PS LA 2005/1 (GA) to achieve this sensible outcome – but this practice statement was withdrawn following Bamford.

6.14 The issues with streaming can be readily appreciated in the context of capital gains and the 50% general CGT discount. The streaming issue is, of course, the denial of the 50% CGT general discount when a trust to company distribution is in play.

6.15 Maintaining the example used above in which there is a net capital gain of $100,000, and gross rental income of $50,0000 and net rental income of $20,000.

6.16 In this instance the trustee wishes to cause the capital gain to be assessed in the hands of an individual (say Mrs A) and the net rental income in the hands of a company, A Co. If it is assumed that the Trust Deed has all of the usual income characterisation and streaming provisions and the Deed adopts subsection 95(1) terms, the outcome readily appears.

6.17 The income entitlements are:

	$	
A Co	20,000	comprising net rental income
Mrs A	50,000	comprising the capital gain
	70,000	

6.18 If the ATO took the view that streaming was unobtainable the outcome would be:

	$	$ Total
A Co	5,714 + taxable capital gain $28,572	34,286
Mrs A	50,000	50,000
		84,286

6.19 The other area of concern is franking credits. At least there is a ruling on this aspect of streaming, *Taxation Ruling* 92/13 (repealed as of 22 June 2011 because of the Streaming Amendments). The provisions of Subdivision 207-B and in particular ss 207-45 to 207-57 are consistent with flow through of the franked character of a dividend.

6.20 The fact the Example set out immediately below s 207-35(3) of the 1997 Act depends on character maintenance. It is worthwhile setting this Example out in full:

> *"A franked distribution of $70 is made to the trustee of a trust in an income year. The trust also has $100 of assessable income from other sources. Under subsection (1) the trust's assessable income includes an additional amount of $30 (which is the franking credit on the distribution). The trust has a net income of $200 for that income year.*
>
> *There are 2 beneficiaries of the trust, P and Q, who are presently entitled to the trust's income. Under the trust deed, P is entitled to all of the franked distribution and Q is entitled to all other income.*
>
> *The distribution flows indirectly to P (as P is entitled to a share of that net income and has a 100% share of the distribution under section 207-55). P therefore has an amount of assessable income that is equal to its share of the distribution. Under this subsection, P's assessable income also includes the full amount of the franking credit (as P's share of the franking credit on the distribution is $30 under section 207-57). Q's share of the net income therefore does not include any of the franking credit."*

6.21 Clearly the legislation contemplates maintenance of character for the purposes of dividend imputation.

Commissioner's Concern of Division 6 Abuses

6.22 As usual the ATO is driven by the possibility that the decision in Bamford might support some abuse and revenue loss. No matter that their interpretations lead to massive headaches for practitioners.

6.23 This much is exampled by several examples set out *in Practice Statement PS LA 2009/7* which was released prior to the decision in Bamford.

6.24 Examples 1 and 5 in particular show what the ATO is on about.

6.25 Example 1 concerns the trustee of a family trust deriving $250,000 in income during the income year and applying that income to the purchase of a holiday home. The trustee, acting in accordance with a power expressed in the terms of the Trust Deed to do so, determines that the expenditure on the purchase of the house is an outgoing on income account with the effect that the trust law income available for distribution is $5,000. One of the beneficiaries has tax losses.

6.26 The trustee distributes the $5,000 trust law income to the loss beneficiary. The losses cover the tax law income which follows the trust law income to the loss beneficiary.

6.27 The ATO expresses concern about the mismatch of the actual amount to which the beneficiary becomes entitled ($5,000) and the amount of the tax law income flowing to the beneficiary ($250,000) and the tax not paid because of the losses.

6.28 It is difficult to say why this is of concern to them. The true effect of the transaction is to maintain $245,000 in the capital of the trust. The same tax effect would be obtained by distributing all of the $250,000 to the loss beneficiary. There is no tax difference in this illustration. It is unlikely there would be a tax benefit for the purposes of Part IVA. The most likely explanation for the transaction is the financial risk the loss beneficiary has been exposed to. If the beneficiary became entitled to call on the trustee to pay him or her $250,000 the creditors may be able to stake a claim to that amount. It is a neat and sensible piece of asset protection planning.

6.29 Example 5 is about a trust which has distinct income and capital beneficiaries. The trustee has a power to determine whether receipts and outgoings are on income or capital account. The Trust Deed is amended to admit a tax exempt entity as a beneficiary.

6.30 The trust derives $100,000 of income (meaning income according to ordinary concepts) during the income year. The trustee determines that $95,000 of that amount is a capital receipt. The remaining $5,000 is the trust law income according to the Trust Deed. This amount is appointed to the tax exempt beneficiary. All of the tax law income will be assessed to the charity. It would follow that the trustee makes a capital distribution of the $95,000 to a family beneficiary.

6.31 The ATO observe in the Practice Statement that Part IVA might apply in the circumstances. In the writer's view it almost certainly would do so in particular because of the amendment to introduce the tax exempt charity as a beneficiary and the fact that prior year distributions had been made only to family members. A much more challenging (and perhaps more realistic) illustration would arise if the tax exempt charity was already an object and the trustee had made distributions to charities in the past. The Part IVA case in such circumstances would be difficult to make out. This is an example of the acknowledged "apparent unfairness in the resulting administration of the legislation" as noted by the High Court in Bamford at [17].

6.32 The ATO apparently accept that Bamford authorizes characterization of capital receipts as income for the purposes of the Deed but are not so ready to accept that ordinary income may be recharacterised as capital (as in Example 5). They appear to be fortified in this by observations made by the Full Court of the Federal Court in *Forrest v C of T* [2010] FCAFC 6 ("**Forrest**").

6.33 The relevant question before the Court there was whether Mr Forrest was entitled to a deduction for interest he had incurred in relation to funds he had borrowed to acquire units in a unit trust. The outcome turned on whether there was a fixed income component to which the funds related. The Full Court concluded that a power to determine whether any amount received by the trustee was on revenue account or capital account (clause 12 of the Deed) was not a power to change the beneficiaries' rights. In so doing they observed at [11]-[12]:

> *'In our opinion, the power conferred by cl. 12 cannot be exercised by the trustee wrongly to classify a receipt as a capital gain, when the receipt is, in truth, income, and thus deprive the appellant of his interest in the unit component of the trust. Clause 12 is not an unlimited power to be exercised in the trustee's unconfined discretion….*
>
> *Clause 12.2(a) is a power to determine how a distribution to beneficiaries is classified. That limited power is not a power which is capable of altering the beneficiaries' rights. Clause 12 is to be read consistently with the balance of the Trust Deed and an appreciation that it contains various powers of an administrative character. The words used can be given full force honestly to classify income or distributions according to law, as the appellant contended to this Court".*

6.34 It is very difficult to know how far this goes. The issue in Forrest was about whether or not the exercise of the power changed the rights as between classes of beneficiaries. Presumably the ATO would say that the exercise of the power in a case like that in Example 5 was not an "honest" classification of the receipt as capital. Hopefully the issue will not arise very often.

Point of Interest

6.35 A case of interest is *Greenhatch v FCT* [2011] AATA 479 that ostensibly concerned superannuation contributions where the answer to the superannuation question was determined by construing streaming through a trust. The case of is interest for two reasons.

6.36 First, the AAT went out of their way to note the Commissioner's interpretation of Bamford was wrong. At [49] and [50] they said:

> *Much, if not all, of the Commissioner's case turns on his rejection of any underlying conduit theory and his interpretation of the implications of the decision in Bamford.*

The Commissioner's contention that the conduit theory has no role to play is based on foundations with which we do not agree. Accordingly, those foundations do not support the conclusion he seeks to draw.

6.37 Secondly, in relation to Subdivision 207-B of the 1997 Act, being the franking credits provisions, the AAT observed at [63]:

> *Section 207-35 of the 1997 Act has an aspect that makes the conclusion [that] amounts passing through trusts to beneficiaries thereof carry the character and identity that they had in the hands of the trustee more compelling. That section includes an example that contemplates differential distributions in determining the taxation burdens that are imposed on the beneficiaries of the trust.*

6.38 Question: was it necessary to introduce the Streaming Amendments in light of the above comments? Given we have the Streaming Amendments it is of academic interest only.

Streaming Amendments

6.39 The *Tax Laws Amendment (2011 Measures No. 5) Act* 2011 (Cth) was introduced into parliament (as a Bill) on 2 June 2011, was passed unamended and assented to on 29 June 2011. They take effect from 1 July 2010. These dates show how close a call it was as the Streaming Amendments are critical for trustee decisions that were needed to be made on 30 June 2011 – one day after their royal assent.

6.40 Subject to a statement by the Commissioner – extending the time a trustee could make decisions to 31 August 2011, which has anyway passed, but the writers question the Commissioner's ability to alter what trust law[6] requires to be done on 30 June of any year – the Streaming Amendments apply to trustees resolving to deal with trust income and capital gains.

6.41 From the 2011 income year and thereafter taxable capital gains and franked distributions are dealt with under these rules.

6.42 The Streaming Amendments operate by diverting from Division 6 of the 1936 Act the franked distributions and taxable capital gains. They are assessed directly in the hands of the beneficiaries who are presently entitled to them. They do this via Subdivision 207-B of the 1997 Act for franked distributions and via Subdivision 115-C of the 1997 Act for taxable capital gains. However, for the taxable capital gains they must still pass through the method statement in s 102-5(1) of the 1997 Act.

[6] *Trustees of the Estate Mortgage Fighting Fund Trust v FCT* [2000] FCA 981 per Hill J; *Case R105,* 84 ATC 692; *Antonopoulos v FCT* [2011] AATA 431.

6.43 The Streaming Amendments have introduced a new Division 6E into Part III of the 1936 Act to prevent double taxation. It adjusts the Division 6 income and net income of the trust to take out the amounts to which the beneficiary has been made specifically entitled.

6.44 It can be seen that the specific entitlement of the beneficiary or beneficiaries is the critical aspect of the Streaming Amendments. This is required to determine tax liability.

Specific Entitlement

6.45 The notion of a specific entitlement conceals the difficulties of applying the Streaming Amendments to all trusts, be they discretionary, fixed, unit, et cetera. The mechanism by which you become specifically entitled are set out in the relevant Subdivisions: s 115-228 for capital gains and s 207-58 for franked distributions. The provisions seem substantially similar at first look but there are some significant differences.

6.46 A beneficiary is specifically entitled under s 207-58 of the 1997 Act to an amount of a franked distribution made by the trust equal to the amount calculated under the following formula

$$\text{Franked Distribution} \times \frac{\text{Share of net financial benefit}}{\text{Net financial benefit}}$$

6.47 The "net financial benefit" is an amount equal to the financial benefit referable to the franked distribution (after an application by the trustee of expenses that are directly relevant to the franked distribution).

6.48 The term "financial benefit" is already in s 995-1 f the 1997 Act. It means anything of economic value, even if the transaction also imposes an obligation on the entity. Benefits and obligations are to be looked at separately and not set off against each other, but it is the net financial benefit to which the formula looks.

6.49 The "share of the financial benefit" is the amount of the financial benefit referable to the franked distribution specifically linked to the particular beneficiary. The share of the net financial benefit is:

> *… an amount equal to the *financial benefit that, in accordance with the terms of the trust:*
>
> *a. the beneficiary has received, or can be reasonably expected to receive, and*
>
> *b. is referable to the *franked distribution (after application by the trustee of any expenses that are directly relevant to the franked distribution) and*
>
> *c. is recorded, in its character as referable to the franked distribution, in the accounts or records of the trust no later than the end of the income year.*

6.50 Section 115-228 is identical to the discussion above of franked distributions, subject to:

6.50.1 the financial benefit must be referable to the capital gain "after application by the trustee of any losses, to the extent that the application is consistent with the application of capital losses against the capital gain in accordance with the method statement in subsection 102-5(1)"; and

6.50.2 the recording of the financial benefit must be "no later than 2 months after the end of the income year."

Complexities and Going Forward

6.51 An issue to be mindful of is – in fact an issue of significant importance – is that a trust with no "income", which was one of the problems in the Bamford appeals, will not be able to stream franking credits. This will mean that where the franked distributions, together with other ordinary income, is insufficient to more than offset expenses of the trust the franking credits cannot go through to the beneficiaries. The same restriction does not apply in relation to capital gains streamed through the trust.

6.52 Ken Schurgott FTIA, in his paper in the August 2011 *Taxation in Australia* titled "Trust streaming 2011" notes a number of complications that arise from the Streaming Amendments:

> *As will be seen, there are a number of issues which emerge that complicate the legislation over and beyond the rather simple approach adopted prior to the Commissioner's stance on streaming. The things which complicate matters are:*
>
> *a. There can be different outcomes according to the definition of income adopted by the trust deed;*
>
> *b. Significantly different outcomes can result where a beneficiary has not been made specifically entitled to the franked distribution or capital gain. This is most pronounced in relation to capital gains;*
>
> *c. The concept of making a beneficiary entitled to the entire financial benefit from a capital gain or franked distribution is fraught with difficulty, particularly where there are capital losses or directly related expenses; and*
>
> *d. The way in which capital losses and directly related expenses are to be dealt with is confusing.*

6.53 It can be seen from these further issues, and the problem of actually apply what is a simple concept of diverting the amounts to Subdivisions 115-C and 207-B respectively, are anything but straightforward or settled. Indeed, a senior council on the writer's floor, after having advised on

the Streaming Amendments is of the view that this is where future archeologists will find the bones of 21st Century tax lawyers and accountants.

7. Changes to the taxation of trusts – terms to be provided for in a trust document

7.1 Given the changes in the taxation of trusts, it is recommended that trust deed (or any other constituent documents) be reviewed so as to determine:

7.1.1 How income, capital gains and outgoings are accounted for and determined; and

7.1.2 How income, capital gains and outgoings are to be distributed.

7.2 Some of the powers which may be advantageous to have within a trust instrument include:

7.2.1 an accounting policy which is sufficiently broad and allows the trustee to exercise maximum discretion;

7.2.2 the discretion to reclassify and allocate income and capital gains;

7.2.3 the discretion to reclassify and allocate outgoings;

7.2.4 the discretion not to recoup losses (whether income or capital in nature);

7.2.5 the ability to allocate and stream classes of income and capital and their related tax attributes;

7.2.6 and ensure that any unpaid present entitlement / loan provisions are removed, and an ability to hold amounts subject to a sub-trust.

7.3 Some additional powers to be considered include:

7.3.1 whether the trustee has the power to distribute income and / or capital at any time within a tax year;

7.3.2 whether any determination of income (or capital) can be made within the income tax year; and

7.3.3 whether the trustee has a power to determine entitlements with respect to an income tax year after the relevant year.

Accounting policy

7.4 Essential is ensuring that the trust deed provides guidance with respect to an accounting policy that should be used by the trustee. Such an accounting policy should provide sufficient flexibility for the trustee, so that it may depart from generally accepted accounting standards in the event that the trustee considers that it is appropriate to do so.

Reclassifying and allocating income and capital

7.5 As the High Court in *Bamford* accepted that the tax law income of a trust is dependent upon (amongst other things) the definition of that term in the trust deed, regard should be given to the definition of the 'income' as contained in the trusts constituent documents.

7.6 An issue to consider is whether attributed amounts (e.g. franking credits) should be included within the definition of trust income. An issue that arises is that if attributions are included in trust income (and which are not physically 'paid' by a trustee – but which follow certain amounts of income), whether by being included in trust income, and thereby providing that a trustee creates a 'present entitlement' in a beneficiary to an amount that is never received by a trustee, the trustee will be exposed to a claim in relation to amounts that are not actually received by the trustee.

7.7 It is submitted that amounts such as franking credits should be prima facie carved-out of the definition of income. However, the definition should contain discretionary elements to allow a trustee to cause such 'attributed' amounts to fall within the definition of income.

7.8 An approach which may be considered is, in defining trust income:

7.8.1 Provide that it prima facie equals the amount provided for in s 95(1) of the 1936 Act (less any franking credits);

7.8.2 If the tax law approach is not warranted for a particular tax period, then:

7.8.2.1 According to an accounting policy adopted by the trustee; or

7.8.2.2 Any other basis as determined by the trustee; or

7.8.3 In the trustee's absolute discretion, the gross income of the trust.

Reclassifying and allocating outgoings

7.9 In *Cajkusic v FC of T (No 2)* (2006) ATC 4752 ("**Cajkusic**") deductions allowable to a family discretionary trust for payments that were made under an employee benefits trust arrangement in the income tax years ending 30 June 1997 and 30 June 2008 caused there to be a loss within the trust estate.

7.10 As a result of the losses, there was no distributable income of the trust. As a result, the Full Court of the Federal Court held that the lack of distributable income meant that there could be no beneficiary of the trust (for the relevant income tax years) to be "*… presently entitled …*'"pursuant to s 97 of the 1936 Act to any amount.

7.11 It should be noted that the Commissioner's subsequent application for special leave to appeal to the High Court was rejected.

7.12 Cajkusic stands for the proposition that the 'distributable income' of a trust is determined by reference to proper accounting principles, as well as the terms of a trust deed. In this context distributable income is income determined according to accounting principles, and which is distributable amongst the beneficiaries. It does not alter either the income as calculated under accounting principles, of the 'net income' as determined under s 95(1) of the 1936 Act – rather, only gives a trustee the power to determine the distributable amounts.

7.13 As a result of the decision in Cajkusic, it is submitted that a trust deed should give a trustee the power to reclassify, and allocate outgoings, so that there can be 'distributable income' to which beneficiaries are presently entitled.

Discretion not to recoup losses (whether income or capital in nature)

7.14 It is recommended that a trustee have a discretion not to recoup losses (whether of an income or capital nature). That is, a power not to recoup losses which have arisen in the past.

8. Resettlement considerations

8.1 Whenever the terms of a trust are varied, an issue to consider is whether the variation amounts to a 'resettlement'.

8.2 Resettlements relate to changes to a trust relationship which have the effect that a new trust estate comes into existence. According to the High Court in *FC of T v Commercial Nominees of Australia Ltd* [2001] HCA 33 (***"*Commercial Nominees"**), the issue to determine is whether '*… what occurred* … [i.e. the variation] … *was a fundamental alteration in the trust relationship*

established by the original deed, such that it destroyed the necessary continuity of the 'taxpayer'…'.

8.3 A resettlement can have significant income tax, capital gains tax (**'CGT'**) and stamp duty consequences, including that:

8.3.1 the trust property may be disposed of, potentially triggering both stamp duty and CGT liabilities;

8.3.2 carried forward tax benefits may be lost; and

8.3.3 beneficiaries may dispose of their interests in the original trust and acquire interest in a new trust.

8.4 Specifically in the context of CGT, a resettlement may cause either CGT event E1 (s 104-60 of the 1997 Act) or CGT event E2 (s 104-65 of the 1997 Act) to happen.

8.5 In August 2001 the issued a Statement of Principles entitled *Creation of a new trust* (the **"Statement**"). The Statement clarifies when, in the Commissioner's view, changes to a trust gives rise to a new trust. The Commissioner considers that a new trust estate arises where there is a 'fundamental change to a trust relationship' – ie, a change in the essential nature and character of the original trust relationship. Further, the Commissioner considers that a new trust (i.e. a resettlement) may arise in the following circumstances:

- a change in beneficial interest in trust property;
- a new class of beneficial interest (whether introduced or altered);
- a redefinition of the beneficiary class;
- changes in the terms of the trust or the rights or obligations of the trustee;
- changes in the nature of the trust property;
- additions of property which could amount to a new and separate settlement;
- depletion of trust property;
- a change in the termination date of the trust;
- a change in the trust that is not contemplated by the terms of the original trust;

- a change in the essential nature and purpose of the trust; and / or
- a merger of two or more trusts or a splitting of the trust.

8.6 The Commissioner considers that depending on their nature and extent, the above changes may either amount to:

8.6.1 a variation of a continuing trust; or

8.6.2 a fundamental change in the essential nature and character of the trust relationship. In such a case, the original trust may be brought to an end and a new trust created. Whether a new trust is created depends on the terms of the original trust and on the powers of the trustee.

8.7 The High Court in Commercial Nominees held that significant changes to a superannuation fund trust deed did not create a new trust, even though the amending deed had:

8.7.1 changed the name of, and appointed a new trustee to the fund;

8.7.2 introduced a new category of beneficiaries;

8.7.3 changed the fund from a defined benefit fund to an accumulation fund;

8.7.4 appointed a professional management company as administrator; and

8.7.5 allowed membership to be promoted to the public.

8.8 The High Court in *Commercial Nominees* considered that there were three main indicators of the continuity of a trust relationship, being:

8.8.1 the constitution of the trust;

8.8.2 the trust property; and

8.8.3 the membership of the trust.

8.9 Substantial changes any of the above may cause a resettlement.

8.10 The High Court considered that, in order to destroy the necessary continuity, changes in one or more of the above indicators must be such as to terminate the existence of the entity, or to produce the result that the particular trust does not derive the income in question. It was held that the changes made to the trust deed in question were not sufficient to destroy the continuity, primarily because the fund was at all times governed by the same deed, the trust property did not change, and the members before the amendment to the trust deed remained members afterwards. We consider that the amendments discussed above will not cause a resettlement.

8.11 The Commissioner notes in the Statement that administrative changes, such as re-defining trust income (without more) may not cause a resettlement (depending on the context) as it may be administrative in nature.

8.12 However, regard will need to be given to the implications to the membership (i.e. the beneficial entitlements) of the trust, and what implications such an amendment will have on the respective entitlements in a trust. For example, an important consideration will be determining how unallocated / undistributed income is to be dealt with. For example, is such income:

8.12.1 accumulated, and form part of the corpus of the relevant trust estate;

8.12.2 is it distributed to certain default beneficiaries; or

8.12.3 is it held on trust for a specific purpose (e.g. a charitable purpose).

Changes in the Taxation of Trusts

A paper presented by Michael Bennett and Denis Barlin at the NSW Young Lawyers CLE

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Michael Bennett E bennett@sevenwentworth.com.au D 8224 3055 M 0408 029 416
Denis Barlin E dbarlin@wenworthchambers.com.au D 9231 6646 M 0404 848 311

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1. General overview

1.1 The income years ended 30 June 2010 and, more particularly, 30 June 2011 have been very active for the taxation of trusts. Significant events in three areas of trust taxplay activity:

1.1.1 decisions of the Courts and principally the High Court's decision in *Commissioner of Taxation v Bamford* (2010) 240 CLR 481; (2010) 264 ALR 436; [2010] HCA 10 ("**Bamford**");

1.1.2 legislative changes, principally:

1.1.2.1 the new rules set out in *Tax Laws Amendment (2011 Measures No. 5) Act* 2011 (Cth) (the "**Streaming Amendments**") that deal with taxation of franking credits and capital gains in trusts; and

1.1.2.2 the new rules set out in the *Tax Laws Amendment (2010 Measures No. 2) Act* 2010 (Cth) that are principally about Division 7A of Part III of the *Income Tax Assessment Act* 1936 (Cth) (the "**1936 Act**") and companies providing rights to use property, but also contain some trust issues (the "**Div 7A Amendments**"); and

1.1.3 Australian Taxation Office ("**ATO**") activities principally the very controversial draft ruling on unpaid present entitlements, TR 2009/D8.

1.2 Some of these changes have overtaken themselves. For instance, there was at the time – and this paper includes – a discussion of streaming post Bamford (see **heading 4** below). That discussion should be read as having been overtaken by the Streaming Amendments (see **heading 5**).

1.3 And what's more the change is not over. Chapter 2 of the explanatory memorandum to the Bill that introduced the Steaming Amendments makes it clear that the streaming provisions have been introduced as an interim measure to deal with perceived anomalies in the taxation of capital gains and franked distributions pending a comprehensive review of Division 6 of Part II of the 1936 Act.

1.4 The changes made so far give rise to issues themselves and further consequential issues for trusts. In addressing the issues – both outlined above and the consequential issues – this paper will discuss:

1.4.1 Taxation of trusts generally;

1.4.2 The competing views before Bamford;

1.4.3 The context of Bamford and what it means for trusts;

1.4.4 Briefly (as it is not germane to the other issues raised in the paper) what are the Div 7A Amendments and what they mean for trusts;

1.4.5 What are the Steaming Amendments and what they mean for trust;

1.4.6 What a trust deed needs in light of those three issues; and

1.4.7 Amending trust deeds to deal with those three issues.

1.5 The issues are dealt with in this order as they are chronological to their occurring.

2. Taxation of Trusts

2.1 The provisions dealing with the taxation of trust income are contained in Division 6 of Part III of the 1936 Act (which comprises of sections 95 to 102).

2.2 As a result of the enactment of Streaming Amendments, regard should also be given to:

2.2.1 Subdivision 207-B of the *Income Tax Assessment Act* 1997 (Cth) (the "**1997 Act**") – which deals with franking credits obtained by a trust estate; and

2.2.2 Subdivision 115-C of the 1997 Act – which deals with the distribution of capital gains by a trust estate.

2.3 Chief Justice Latham in *Tindal v FC of T* (1946) 72 CLR 608 at 618 observed that the object of Division 6 of the 1936 Act is to "*… secure payment of tax upon the whole of the net income of a trust estate, either from a beneficiary or the trustee, whether the income is paid over to or on account of the beneficiary …*". Further, according to Emmett J in *Bamford v Federal Commissioner of Taxation* (2009) 176 FCR 250 "*… an important assumption underlying Division 6 …* [is] *… that a beneficiary who derives a share of the net income should be in a position to pay out of that income; otherwise, the beneficiary could be placed in a difficult position*."

2.4 The starting point in determining the taxation of trust income is s 97 of the 1936 Act. Relevantly, s 97(1) of the 1936 Act 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; and

(b) the exempt income of the beneficiary shall include:

(i) so much of the individual interest of the beneficiary in the exempt income of the trust estate as is attributable to a period when the beneficiary was a resident; and

(ii) so much of the individual interest of the beneficiary in the exempt 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;

except to the extent to which the exempt income to which that individual interest relates was taken into account in calculating the net income of the trust estate; and

(c) the non-assessable non-exempt income of the beneficiary shall include:

(i) so much of the individual interest of the beneficiary in the non-assessable non-exempt income of the trust estate as is attributable to a period when the beneficiary was a resident; and

(ii) so much of the individual interest of the beneficiary in the non-assessable non-exempt 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]

2.5 That is, s 97 of the 1936 Act provides that where a beneficiary, who is not under a legal disability is presently entitled to a "*… share of the income of the trust estate …*", the assessable income of:

2.5.1 a resident beneficiary includes the beneficiary's share of the '*… net income of the trust estate …*'; and

2.5.2 a non-resident beneficiary includes so much of the beneficiary's share of the net income of the trust as is attributable to sources in Australia.

2.6 It should be noted that the term "net income of the trust estate" for the purposes of s 97 of the 1936 Act is defined in s 95(1) of the 1936 Act. However, the term "*… the income of the trust estate …*" as contained in s 97 of the 1936 Act is not defined in the 1936 Act.

2.7 Subsection 95(1) of the 1936 Act defines the term 'net income', in relation to a trust estate as:

> ***net income**, 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 Division 393 of the Income Tax Assessment Act 1997 (Farm management deposits) 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.*

2.8 For completeness, it should be noted that:

2.8.1 s 98 of the 1936 Act provides that the trustee is liable to tax on behalf of a beneficiary where the beneficiary is presently entitled to a share of the income of a trust estate, but the beneficiary is under a legal disability;

2.8.2 ss 99 and 99A of the 1936 Act apply to subject the trustee to tax where there is some part of the net income of a trust estate that is not subject to tax under either of ss 97 or 98 of the 1936 Act. The difference as between s 99 and s 99A of the 1936 Act is the rate of tax applicable. Typically, the trustee will be subject to tax under section 99A of the 1936 Act at a penal rate of tax equal to the maximum rate of tax (currently 45%). However, the Commissioner has a discretion to apply s 99 of the 1936 Act in certain circumstances, in which case the trustee will be subject to tax at the normal marginal rates of tax.

3. The two competing views before the decision in Bamford

3.1 There has been, for some time, two competing views in the taxation of trust income – the proportionate view and the quantum view.

Proportionate approach

3.2 *David & Anor v FC of T* 89 ATC 4377 contains an example of the application of the proportionate approach (which according to the High Court's decision in Bamford, is the correct approach).

3.3 The proportionate view looks to the share (or proportion) of trust law income of a trust to which a beneficiary is "presently entitled", and then applies that share or proportion to the net income of a trust estate to calculate how much of the net income is to be included in the beneficiary's assessable income.

3.4 As an example, if a beneficiary is entitled to one half of the trust law income, then the beneficiary must include half of the net income in their assessable income – irrespective of whether it is more or less than the amount of the trust law income to which they are entitled.

(a) Implications if tax law income exceeds trust law income

3.5 Under this approach, a beneficiary who is "presently entitled" to trust law income may be required under s 97(1) of the 1936 Act to include in their assessable income an amount of net income which is greater than the amount of trust law income to which they are entitled, and to which has been paid or distributed to them.

3.6 That is, they may be subject to tax on amounts whish they will not receive, and are not entitled to actually receive.

3.7 This outcome seems to be contrary to the objectives of Division 6 of the 1936 Act as outlined by Emmett J in the Full Court of the Federal Court decision in *Bamford v Federal Commissioner of Taxation* (2009) 176 FCR 250 (discussed above).

(b) Implications if trust law income exceeds tax law income

3.8 However, where the net income of a trust estate for the purposes of s 95(1) of the 1936 Act is less than the trust law income, then a beneficiary who is "presently entitled" pursuant to s 97(1) of the 1936 Act will be required to include in their assessable income an amount which is less than the trust law income to which they will be entitled, and which will be paid to them.

3.9 As a result, an on the assumption that the beneficiaries are "presently entitled" to the whole of the trust law income, with the result that the whole of the "net income" of the

trust estate is included in their assessable income pursuant to s 97(1) of the 1936 Act, there can be no part of the net income to which ss 99 or 99A of the 1936 Act applies.

3.10 There is still a question as to whether, in these circumstances, the beneficiary must include the excess amount (i.e. the amount not included under s 97(1) of the 1936 Act) under some provision of the tax acts (e.g. CGT event E4 as contained in s 104-70 of the 1997 Act).

The quantum approach

3.11 The quantum approach (which is no longer good law) is based on the proposition that a beneficiary can only be presently entitled to such amount(s) of trust income as they actually receive.

3.12 Further, any part of the net income of the trust estate which exceeds the amount to which the beneficiary is presently entitled is not income to which the beneficiary is presently entitled to pursuant to s 97 of the 1936 Act, with the result that the trustee is subject to tax on it under s 99A of the 1936 Act (unless the Commissioner exercises it discretion to cause it to be subject to tax under s 99).

3.13 As with the proportionate approach, where the net income of the trust estate for s 95(1) of the 1936 Act purposes is less than the trust law income, such that the beneficiary receives an amount which is greater than the amount included in their assessable income, the question arises as to how the excess is to be taxed (if at all).

4. Bamford

4.1 Bamford was a much anticipated decision. In the view of some[1] the decision was a missed opportunity to settle an area of the trust law and tax law that has been crying out for correction: *Bamford* at [17] citing Hill J in *Davis v Federal Commissioner of Taxation* (1989) 86 ALR 195 at 230.

Background to Bamford

4.2 Mr and Mrs Bamford were beneficiaries of a discretionary trust known as the Bamford Trust (the "**Trust**"). The trustee of the Trust was P&D Bamford Enterprises Pty Ltd. Mr and Mrs Bamford were also the directors and employees of P&D Bamford Enterprises Pty Ltd.

[1] Slater QC *Taxation Trust Income After* Bamfor'ds *Case*, 26th National TIA Convention, 2-4 March 2011

4.3 During the 2000 income tax year, the Trust made a contribution to an offshore superannuation fund on behalf of Mr and Mrs Bamford. The contribution was sourced from borrowings by the corporate trustee, in its capacity as trustee of the Trust.

4.4 For the purposes of determining the "net income" of the Trust for the 2000 income tax year, the corporate trustee (in its capacity as trustee of the Trust) claimed a deduction for both the contribution made to the offshore superannuation fund, and the interest on the borrowed funds used to make the contribution. The total deduction claimed was $191,701.

4.5 After taking into account of the deductions, the "net income" of the Trust for that year was distributed to specified beneficiaries of the Trust. Included in the distribution were Mr and Mrs Bamford, who both had specified amounts distributed to them.

4.6 Specifically, for that income tax year (i.e. the 2000 income tax year), the trustee of the Trust allocated amounts to certain beneficiaries of the Trust, including a payment of $34,000 each to Mr and Mrs Bamford. However, the trustee of the Trust did not have sufficient funds to pay the full amount of $34,000, and instead paid them $33,872, being what the trustee of the Trust thought was the total remaining trust funds.

4.7 The amount initially distributed by the trustee of the Trust was $187,530.

4.8 In 2005, the Commissioner of Taxation applied the anti-avoidance provisions so as to disallow the deductions of the Trust (for the 2000 income tax year) for the superannuation contribution and the interest. As a result of the denial of the deductions, for the purposes of the 2000 income tax year the Trust's taxable income exceeded its accounting income.

4.9 The decision essentially dealt with two things:

4.9.1 whether the 'proportionate approach' applied in the event that tax law income exceeds accounting / trust income; and

4.9.2 whether the trust deed of the trust could characterise an amount of capital gains as income of the Trust.

Application of the proportionate view

4.10 As a result of the denial of the deduction, the Trust's taxable income increased by $191,000. The Commissioner issued amended income tax assessments to both Mr and Mrs Bamford. Pursuant to the assessments, the Commissioner contended that Mr and Mrs Bamford were liable to tax on the increased 'net income' of the Trust based on the proportionate share of the amount by which the taxable income of the trust exceeded the accounting income.

4.11 Indeed, the Commissioner sought to assess Mr and Mrs Bamford on an extra $34,624, on the basis that that amount represented the 'share' of the additional $191,000 as their share (i.e. 18%) of the previous amount (i.e. $187,530) actually distributed.

4.12 However, the taxpayers argued that they should only be taxed on the difference between the $33,872 which they actually received, and the specific amount of $34,000 which was originally allocated to them (i.e. an amount of $128 each).

4.13 The High Court rejected the taxpayer's argument, and in doing so applied the "proportionate approach".

4.14 The High Court took a two step approach in dealing with this issue:

4.14.1 First – the High Court held that the term "*… income of the trust estate …*" as contained in s 97(1) of the 1936 Act refers to distributable income, being income as determined by the trustee taking into account the terms of the trust (e.g. the trust deed) and appropriate accounting principles.

4.14.2 Secondly – after ascertaining the "share" of the distributable income to which a beneficiary is presently entitled, s 97(1) of the 1936 Act then requires that "*… that share of the net income of the trust estate …*" be ascertained, being the shares of the taxable income and not the distributable income.

4.15 Further, it was held that the inclusion within s 97(1) of the 1936 Act of the defined phrase "*… net income of the trust estate …*" and the undefined term "*… the income of …* [the] *… trust estate …*" indicated that these were intended to have different meanings. As a result, the term "*… the income of …* [the] *… trust estate* " had a different and defined meaning for taxation purposes.

4.16 The Court at [45] held that the analysis of Sundberg J in *Zeta Force Pty Ltd v Commissioner of Taxation* (1998) 84 FCR 70 at 74-75 should be applied:

> *The resolution of the second issue of construction is to be found in the analysis by Sundberg J in* Zeta Force Pty Ltd v Commissioner of Taxation *… . His Honour dealt with the first issue of construction to the same effect as that just explained, saying:*
>
> > *"The words 'income of the trust estate' in the opening part of s 97(1) refer to distributable income, that is to say income ascertained by the trustee according to appropriate accounting principles and the trust instrument. That the words have this meaning is confirmed by the use elsewhere in Div 6 of the contrasting expression 'net income of the trust estate'. The beneficiary's 'share' is his share of the distributable income."*
>
> *Sundberg J then continued:*
>
> > *"Having identified the share of the distributable income to which the beneficiary is presently entitled, s97(1) requires one to ascertain 'that share of the net income of the trust estate'. That share is included in the beneficiary's assessable income. The expression 'net income of the trust estate' in par (a)(i) has the meaning given it by s 95(1) – taxable income as opposed to distributable income. The words 'that share' in par (a)(i) refer*

back to the word 'share' in the expression 'a share of the income of the trust estate', and indicate that the same share is to be applied to an income amount calculated according to a different formula (taxable income as opposed to distributable income). Since the income amount may differ according to which formula is applied, the natural meaning to give to 'share' where it appears for the second time is 'proportion' rather than 'part' or 'portion'. When Parliament wanted to convey the latter meaning, as it did in ss 99 and 99A, it used the word 'part'.

The contrast between the expressions 'share of the income of the trust estate' and 'that share of the net income of the trust estate' shows that the draftsman has sought to relate the concept of present entitlement to distributable income, and not to taxable income, which is, after all, an artificial tax amount. Once the share of the distributable income to which the beneficiary is presently entitled is worked out, the notion of present entitlement has served its purpose, and the beneficiary is to be taxed on that share (or proportion) of the taxable income of the trust estate."

4.17 For the 2000 income year, the "net income" of the Trust included the amount of $191,701 which should not have been claimed as a deduction in the tax return of the Trust. As a result, the High Court held that the assessable income of Mr and Mrs Bamford should include a share of that amount, equivalent to the share they each received of the distributable income.

Whether the trust deed could re-characterise amounts

4.18 The trust deed of the Trust gave the trustee the discretion to determine whether a particular receipt should be treated as income or capital.

4.19 The trustee relied on this power to pass a resolution to distribute the first $60,000 of net income, "*… including …* [the] *…. capital gain …*" to Mr and Mrs Bamford in equal shares.

4.20 The Commissioner argued that the capital gain was not income of the Trust. Further, since there was no income, no beneficiary could be 'presently entitled' to the amount in question, the trustee of the Trust should be assessed at the special rates.

4.21 The High Court held that the term "income" as contained in s 99A of the 1936 Act should be interpreted as income of the trust estate, as understood in trust law.

4.22 As a result, the net capital gain of the Trust became the income of the Trust after the trustee exercised its discretion to characterise the capital gain as income of the Trust.

Outcome for Trust Distributions

4.23 There is no room for doubt that Bamford establishes that:

4.23.1 income of the trust estate identified in s 97(1) of 1936 Act is to be determined according to any directions set out in the Trust Deed;

4.23.2 the share of the net income attributable to a beneficiary is to be determined in the same proportions in which the beneficiary enjoys the present entitlement to the share of the income of the trust.

4.24 In this first regard, the Court made it clear that the general rules regarding apportionment between capital and income of receipts and outgoings was largely based on assumptions which could be displaced by the terms of the trust instrument: Bamford at [17]. The general law of trusts operates to give meaning to the term "the income of the trust estate".

4.25 The determination of present entitlement to a share of the income is a process of trust administration. The decision of the Full Court of the Federal Court in *C of T v Totledge Pty Ltd* (1982) 40 ALR 385 at 393 is quoted in support: Bamford at [39]. The High Court distinguished its own decision in *C of T v Australia and New Zealand Savings Bank Ltd* (1998) HCA 53 (Bamford at [39]) as not relevantly addressing the issue. Finally, the Court observed that the Commissioner's lack of consistency in wishing to exclude "statutory income" from "income of the trust estate" did not assist his argument that "income" means "income according to ordinary concepts": Bamford at [41].

4.26 On the meaning of the term "share of the net income" the High Court adopted the proportionate approach advocated by Sunberg J in *Zeta Force* (discussed above).

4.27 What does this translate into for trustees making decisions in respect of trust distributions for the 2010 income year?

4.28 There are a number of relevant observations to be made.

4.29 First, if the Trust Deed provides a formula for determining the income of the trust then that formula will determine the entitlement of the beneficiaries to income. If, for example, the Deed contains words to the following effect:

> *"The net income of the trust is an amount equal to the amount determined in accordance with subsection 95(1) of the* Income Tax Assessment Act 1936 *but reduced by any amount which would otherwise be included by application of Division 207 of the* Income Tax Assessment Act 1997*".*

4.30 Throughout this paper "subsection 95(1) terms" means an amount adjusted for the franking credit gross up. The issue of grossing up is considered below in the context of using the full tax exemption including the franking rebate available to children.

4.31 Leaving aside the elimination of any gross up for franking credits (which itself is affected by the Streaming Amendments as discussed below) the amount of net income for trust law purposes

will equal the tax law income. The two will coincide so that there should, in the ordinary course, be no amount assessable to the trustee under s 99A of the 1936 Act.

4.32 Secondly, if the Trust Deed is silent then "ordinary income" principles apply. Just what they are is difficult to say. The ATO has expressed the view that income of a trust is income according to ordinary principles. This is not the same thing as accounting income determined in accordance with accounting principles. It requires a dissection of receipts into:

4.32.1 income according to ordinary principles;

4.32.2 income which is not ordinary income;

4.32.3 capital receipts.

4.33 Following that dissection, the expenses must be apportioned accordingly.

4.34 This is, of course, all too much. Many trust deeds will have a clause like that in Bamford which allows the trustee to determine whether a receipt is capital or income. Others will have very broad powers allowing the trustee to determine the basis on which income of the trust is to be worked out.

4.35 If these powers exist they should be used to avoid uncertainty brought about by the "ordinary income" approach. If they do not exist then the deed should be to give the trustee such a power. Whether such an amendment will amount to a resettlement, which might have adverse capital gains tax (and stamp duty) consequences, is discussed at **paragraphs xx** below.

4.36 Thirdly, because the proportionate approach has prevailed, a strict application of that rule will mean that great care needs to be taken when seeking to direct a specific amount of tax law net income to a particular beneficiary with absolute certainty e.g. the maximum amount to a child which escapes the punitive rates under Division 6AA of the 1936 Act. This issue is illustrated in the Examples which follow.

4.37 Fourthly, the High Court decision says nothing about streaming of trust income. The matter was not in issue. The uncertainty about streaming of income according to its character remained unabated, until the Streaming Amendments.

4.38 Finally, the ATO has done away with the benevolent "capital beneficiary" approach set out in Practice Statement PSLA 2005/1 (GA) on and from 13 October 2010.

Examples

4.39 The best way to illustrate these points is by way of example. In the examples which follow the following facts apply in relation to the A Family Trust for the income year ended 30 June 2010:

Receipts:

rent	$50,000
net capital gain	$100,000

Expenses:

rental expenses	$10,000
interest	$20,000

4.40 The interest relates to the rental property only. The discountable capital gain was made on the sale of shares in a listed company. The intended beneficiaries are Mr and Mrs A and their two children both under 18.

4.41 Because of the low income rebate the following no-tax thresholds apply to minors:

Income Year end 30 June	**$**
2010	3,000
2011	3,333

4.42 If the income constitutes fully franked dividends the cash payment thresholds and grossed up taxable income amounts are:

Income Year end 30 June	**$ cash**	**$ taxable income**
2010	6,300	9,000
2011	7,000	10,000

4.43 These figures have considerable significance for trustees seeking to hit the no tax "sweet spot" for a distribution to a child.

(a) Subsection 95(1) terms apply – no "balance approach"

4.44 The taxable capital gain is $50,000. Accordingly, the distributable trust income is $70,000.

4.45 For 2010 a minor may be distributed $3,000 with no tax liability if entitled to the low income rebate (see comments above).

4.46 The trust distribution minutes might give effect to the following:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000

70,000

4.47 The tax law results will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.48 The cash in the trust will include the $50,000 covered by the 50% general CGT discount. This is not income and can be dealt with as capital. As this is a discretionary trust it can be distributed without tax consequences.

(b) Ordinary income applies – no "balance approach"

4.49 In this instance the trust distribution minutes will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	7,000
Mr A	7,000
	20,000

4.50 The tax law results will be:

	$
Child 1	$3{,}000 + {}^{3,000}/_{20,000} \times \$50{,}000$
Child 2	$3{,}000 + {}^{3,000}/_{20,000} \times \$50{,}000$
Mrs A	$7{,}000 + {}^{7,000}/_{20,000} \times \$50{,}000$
Mr A	$7{,}000 + {}^{7,000}/_{20,000} \times \$50{,}000$

4.51 The final results:

	$
Child 1	10,500
Child 2	10,500
Mrs A	24,500

Mr A	24,500
	70,000

4.52 This is a strict application of the proportionate approach.

4.53 Each of the children will pay tax on $7,500 at the Division 6AA punitive rates of 45%. This is not a good result.

(c) Subsection 95(1) applies – "balance approach" used

4.54 Trust minutes:

	$
Child 1	3,000
Child 2	3,000
Mrs A	half of the balance
Mr A	half of the balance

4.55 Trust income entitlements:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.56 The tax law result:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.57 This is the same outcome as where no "balance approach" is applied – but see below for the effect of a tax adjustment.

(d) Ordinary income applies – "balance approach" used

4.58 Trust minutes

	$
Child 1	3,000
Child 2	3,000
Mrs A	half of the balance
Mr A	half of the balance

4.59 Trust income created will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	7,000
Mr A	7,000
	20,000

4.60 The tax law results will be:

	$
Child 1	$3{,}000 + {}^{3,000}/_{20,000} \times \$50{,}000$
Child 2	$3{,}000 + {}^{3,000}/_{20,000} \times \$50{,}000$
Mrs A	$7{,}000 + {}^{7,000}/_{20,000} \times \$50{,}000$
Mr A	$7{,}000 + {}^{7,000}/_{20,000} \times \$50{,}000$

4.61 The final results:

	$
Child 1	10,500
Child 2	10,500
Mrs A	24,500
Mr A	24,500
	70,000

4.62 Again there is no difference. However, the "balance approach" is more realistic because it is unlikely that the trust income or tax law income will be known as at any 30 June. In reality these figures are not known until the accounts are drawn later in the calendar year.

(e) Tax Law Adjustments

4.63 It is often important to anticipate an adjustment to the trust's tax law income especially where there is something contentions going on.

4.64 As has been seen the tax law result will follow on a proportionate basis the entitlements to income created under the Deed. To test the outcome it is assumed in the above examples that the trustee failed to recognise $10,000 of rental income (say the trustee at first considered that the income was to be deferred until the 2011 income year) but was in fact wrong about this.

4.65 How do the various approaches deal with such an adjustment?

Example (a) – subsection 95(1) applies (but no "balance approach")

4.66 The trust law entitlements and tax law results were the same:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.67 The tax law adjustment will increase both the trust law entitlement and the tax law income by $10,000. The Trustee has not dealt with this $10,000 and, without an operative default beneficiary clause, it will be assessed to the Trustee under section 99A of the 1936 Act.

4.68 The trust law entitlements and tax law result will be:

	$
Child 1	3000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
Trustee	10,000
	80,000

4.69 However, if there is no streaming of the capital gain (with the effect that all beneficiaries are entitled to a proportionate part of the capital gain) that part of the capital gain reflected in the income to which no beneficiary is presently entitled will be grossed up for the loss of the 50% general CGT discount. Five eighths of the $10,000 adjustment assessed to the Trustee is capital gain. As a result the share of the net income assessable to the Trustee will be increased by $6,250.

4.70 The final result will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
Trustee	16,250
	86,250

4.71 This is a costly outcome.

Example (c) – subsection 95(1) but using a "balance approach".

4.72 The trust law entitlement and tax law result were the same.

	$
Child 1	3,000
Child 2	3,000
Mrs A	half of the balance
Mr A	half of the balance

4.73 The unadjusted result was:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.74 The adjusted trust law entitlement and tax law result will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000 + 5,000
Mr A	32,000 +5,000
	80,000

4.75 The "balance approach" together with adoption of s 95(1) terms directs all of the tax law result from an adjustment made by the ATO to the balance beneficiaries.

4.76 If the balance distribution has been used Mr and Mrs A will "enjoy" a further $5,000 of income entitlement (it now having been correctly determined) and a further $5,000 of tax law net income each. No amount will be assessed to the trustee.

4.77 There is an argument that the beneficiaries have not become presently entitled to the amount of the adjustment to the trust law net income as it was not ascertained at the end of the income year. In the writer's opinion the trust law net income was always the amount as correctly adjusted by the ATO. There was never any uncertainty about it. It is simply the case that the trustee and ATO had not properly determined the correct quantum of income.

4.78 In practical terms how have the Courts looked at the "balance approach"? It has not come up that often.

4.79 The decision of Cooper J in *BRK (Bris) Pty Ltd v C of T* [2001] FCA 164 might at first blush give cause for concern. There the Court considered the operation of the default beneficiary clause in the Trust Deed. The distributions had been:

1993 income year:

"Hendon Unit Trust 100%

and Resolved that should the Commissioner of Taxation disallow any amount as a deduction or include any amount in the assessable income of the Trust, such amount or amounts are to be deemed distributed on 30th June 1993 in the same proportions as listed above to the beneficiaries listed above".

1994 income year:

(a) The sum of $304,021.72 to Westside Commercial Centre Pty Ltd as trustee of the Hendon Unit Trust for its absolute benefit.

(b) The following sums to the following beneficiaries for their absolute respective benefits: NIL

(c) The Balance to Jessica Wagner and Bill Wagner equally between them for their absolute benefit.

1995 income year:

Hendon Unit Trust	*First $220,000*
Northbourne Trust	*Next $100,000*

Wilhelm J Wagner and Jessica O Wagner	*Remainder of balance equally*

4.80 The same "variation of income" clause as in 1993 applied in this year.

4.81 It would appear that the Trust Deed did not adopt subsection 95(1) terms and that income was ordinary income.

4.82 It was found that the Hendon Unit Trust was not an object of the Trust and the distribution of income to it failed. The default beneficiaries clause distributed income in default of appointment to the beneficiaries described in the Schedule to the Deed as tenants in common. This was the usual wide class of family objects.

4.83 The Court concluded that the default beneficiary clause did not operate as at 30 June because the trustee had a reasonable time after the end of the income year in which to decide to distributed or accumulate.

4.84 The question arose as to whether the balance clause in the 1994 and 1995 determinations operated to take the amounts which the Trustee had attempted to distribute to the Hendon Unit Trust to Mr and Mrs Wagner. It was concluded that this was not the effect of the distribution minute and, as a result, the Trustee was assessable under section 99A.

4.85 At [40] Cooper J concluded:

> *"In my judgment the submission is misconceived. In the 1994 income year the clear intention of the applicant was to appoint to Mr and Mrs Wagner only so much of the Trust income, if any, as exceeded $304,021.72 in addition to any income in excess of that amount in the event that the appointment to WCC should fail. The position is no different in respect of the 1995 year. The trustee purported to appoint discrete amounts of income to the Hendon Unit Trust as to the first $220,000 and to the Northbourne Trust as the next $100,000. Finally, as to any remainder after the application of the first $320,000 of income, that remainder was to be appointed to Mr and Mrs Wagner; they did not as a matter of construction or intention on the part of the trustee, take by default all of the income in the event of failure of the other two appointments."*

4.86 Rather than being a cause for concern about the "balance approach" the decision of Cooper J on this point supports its operation. The specific quantum entitlements fix the income (and tax where s 95(1) terms apply) at the amount specified in the Trustee's determination. If the gift fails it does not flow to the balance beneficiary but to the default beneficiary or, in the alternative, there is no such entitlement created, giving rise to a s 99A assessment to the trustee.

4.87 Further comfort can be obtained from observations made in *C of T v Ramsden* [2005] FCAFC 39. In that case the Court was concerned with the issue whether a beneficiary had effectively renounced a distribution of income.

4.88 The distribution minutes for the 1996 income year provided:

"Steve Hart Family Holdings No.2	*$17,295*
Steve Hart Family Holdings No.3	*$6,639*
Unlimited Aerobatic Discretionary Trust	*$34,810*
The Adcock Practice Trust	*$429,000*
Troy B Hart	*$4,750*
Steven I Hart	*The Balance"*

4.89 It was agreed that the Adcock Practice Trust did not qualify as a beneficiary. The default beneficiary clause provided for income which had not been appointed prior to year end to be held for Steven Hart and his three children as tenants in common. The ATO assessed each of the default beneficiaries to one quarter of the amount which had failed to be appointed to the Adcock Practice Trust.

4.90 The argument was pressed before the primary judge that the income should pass by way of the balance distribution to Steven Hart: Ramsden at [38] to [41]. Justice Spender's rejection of this argument was confirmed by the Full Court. It was observed at [2005] FCAFC 39 at [72]:

> *"We agree with this construction. 'The Balance' does not include the amounts which precede "The Balance" in the resolution of 30 June 1996.*
>
> *'The Balance' is the Income of the Trust for the year ended 30 June 1996 other than the amounts which precede it in the resolution in question, whether effectively appointed or not".*[2]

4.91 This observation supports the "balance approach" taken in this paper where there have been effective distributions. Note, however, that it will not work where a distribution is ineffective. In such a case the adjustment will be assessed to the default beneficiary, if there is one, or to the trustee.

Example (d) – Ordinary Income with balance approach applying

4.92 The trust law entitlements were:

	$
Child 1	3,000

[2] [2005] FCAFC 39 at para. 72.

Child 2	3,000
Mrs A	half of the balance
Mr A	half of the balance

4.93 Trust income entitlements:

	$
Child 1	3,000
Child 2	3,000
Mrs A	7,000
Mr A	7,000
	20,000

4.94 The tax law result was:

	$
Child 1	10,500
Child 2	10,500
Mrs A	24,500
Mr A	24,500
	70,000

4.95 When the tax law income is adjusted by $10,000 there is no change to the trust law result. The tax law result will be:

	$
Child 1	$10,500 + {}^{10,500}/_{70,000} \times \$10,000$
Child 2	$10,500 + {}^{10,500}/_{70,000} \times \$10,000$
Mrs A	$24,500 + {}^{24,500}/_{70,000} \times \$10,000$
Mr A	$24,500 + {}^{24,500}/_{70,000} \times \$10,000$

4.96 The final result will be:

	$
Child 1	12,000
Child 2	12,000
Mrs A	28,000
Mr A	28,000

	80,000

4.97 The result has only become worse from a Division 6AA income perspective.

Will a "default beneficiary" clause in the Deed assist?

4.98 An income default beneficiary clause would be expressed something like:

> *"If the Trustee has not determined to distribute all of the net income of the Trust by the end of the Income Year the Income Default Beneficiary will be absolutely entitled to that part of the net income which has not been distributed."*

4.99 The term "Income Default Beneficiary" will be appropriately defined to identify individuals or companies.

4.100 In Example (a) – subsection 95(1) terms but no "balance approach" – a default beneficiary clause would have deflected the tax adjustment from the trustee to the default beneficiary.

4.101 In Example (b) – ordinary income but no "balance approach" – the default beneficiary clause would have no effective operation as all of the trust law/tax law income has been accounted for.

4.102 The trust entitlements were:

	$
Child 1	3,000
Child 2	3,000
Mrs A	7,000
Mr A	7,000
	20,000

4.103 The tax law result was:

	$
Child 1	10,500
Child 2	10,500
Mrs A	24,500
Mr A	24,500
	70,000

4.104 If the tax law income is increased by $10,000 the trust law income does not alter. The tax law adjustment is apportioned according to the trust law income apportionments, as follows:

	$
Child 1	10,500 + $^{3,000}/_{20,000}$ x 10,000
Child 2	10,500 + $^{3,000}/_{20,000}$ x 10,000
Mrs A	24,500 + $^{7,000}/_{20,000}$ x 10,000
Mr A	24,500 + $^{7,000}/_{20,000}$ x 10,000[3]
	70,000

4.105 The final tax results will be:

	$
Child 1	12,000
Child 2	12,000
Mrs A	28,000
Mr A	28,000
	80,000

4.106 In Example (c) – subsection 95(1) terms and a "balance approach" – the default beneficiary clause has no role to play because the adjustment will always be directed to the balance beneficiary.

4.107 In Example (d) – ordinary income and "balance approach" – the default beneficiary clause has no need to operate because the tax adjustment will simply be apportioned in accordance with the trust law entitlements which don't change.

Summary re Tax Adjustments

Trust Accounting Basis	Tax Law Income	Trust Income	Adjustment to (if no default beneficiary)	Adjustment to (if there is a default beneficiary)
subsection 95(1) – no "balance approach"	+ $100	+ $100	Trustee	Default Beneficiary
subsection 95(1) – "balance approach"	+ $100	+ $100	Balance Beneficiaries	Balance Beneficiaries
ordinary income – no "balance approach"	+ $100	no change	All Beneficiaries	All Beneficiaries
ordinary income – "balance approach"	+ $100	no change	All Beneficiaries	All Beneficiaries

[3] The proportions remain the same whether the trust law or tax law results are used.

Guidance from Bamford

4.108 As the High Court observed in Bamford at [17]:

> *"… both sides in argument on the present appeals accepted that whichever of the competing constructions of Div 6 were accepted examples could readily be given of apparent unfairness in the resulting administration of the legislation"*

4.109 In reaching the conclusion that the terms of the Trust Deed determine the trust income to which a beneficiary may be made entitled the High Court has gone very far towards resolving most of the problems and uncertainties which confronted practitioners and the trustees and beneficiaries they advise. With a good understanding of the terms of the Trust Deed as they effect trust distributions most distribution problems can be addressed.

4.110 As has been demonstrated in the above worked examples adopting a s 95(1) terms plus "balance approach" achieves the following:

4.110.1 the quantum of tax distribution to children can be locked in.

4.110.2 any "normal" tax adjustment will flow to the balance beneficiaries.

4.110.3 if used in conjunction with a default beneficiary clause ineffective distributions can also be dealt with.

4.111 The subsection 95(1) but without a "balance approach" can lead to:

4.111.1 an assessment of the tax adjustments to the trustee under section 99A;

4.111.2 clawback of any general CGT discount.

4.112 This can be addressed by using a default beneficiary (of course the default beneficiary should not be a company where the general CGT discount is involved).

4.113 The balance approach together with a considered default beneficiary is to be preferred as the outcome is more predictable.

4.114 The ordinary income approach is problematic because it is:

4.114.1 too difficult to calculate what is net ordinary income;

4.114.2 and tax law adjustments will be spread across all beneficiaries (as there is no adjustment to the net income).

5. Div 7A Amendments

5.1 Division 7A of Part III of the 1936 Act deals with accessing wealth in private companies without accounting for the tax that would otherwise be payable on the value accessed. It focuses on three means of accessing wealth in private companies – payments from a private company, loans from a private company or the forgiveness of a debt by a private company to an associate of that company.

5.2 In 2010 there were two broad changes to the Division 7A interacts with trusts:

5.2.1 The Div 7A Amendments; and

5.2.2 The Commissioner's position in *Taxation Ruling 2010/3* and *Practice Statement Law Administration* 2010/4.

5.3 The changes to Division 7A include the insertion of an introductory note to Division 7A stating:

> An amount may also be included in the assessable income of a shareholder or shareholder's associate if:
>
> (a) a company has an unpaid present entitlement to income of a trust; and
>
> (b) the trustee makes a payment or loan to, or forgives a debt of, the shareholder or associate.
>
> (See Subdivisions EA and EB.)

5.4 This note is of interest as it strongly suggests that Subdivision EA is a 'code' which is intended to capture arrangements where there is an unpaid present entitlement subsisting between a trust and a corporate beneficiary and there is then a loan, payment or forgiveness that occurs between the trustee and a shareholder or an associate of a shareholder in the corporate beneficiary.

5.5 This should be contrasted with the position in the ATO *Taxation Ruling* 2010/3 where the ATO assert that subdivision EA has much more limited effect, where they generally restrict its operation to the situation where there is a sub-trust in existence between a trustee and a corporate beneficiary and there is then loan, payment or forgiveness involving a shareholder or an associate of a shareholder and the trustee of the sub-trust.

5.6 In the 31 March 2010 NTLG meeting the professional bodies questioned the ATO as to whether the introduction of this provision into Division 7A cast doubt on the position in their draft ruling. The meeting agenda includes the following discussion:

> The ATO does not see a conflict between the legislation of provisions dealing with unpaid present entitlements and the position set out in Draft Ruling TR 2009/D8.

This is because, contrary to the premise of the question, under Draft Ruling TR 2009/D8 unpaid present entitlements will retain that status for Division 7A purposes in many situations, including where:

- the amount representing the UPE is physically held on sub-trust for the sole benefit of the private company beneficiary;
- the amount representing the UPE is being used by the trustee but all benefits from this use are held for the sole benefit of the private company; or
- the private company beneficiary is not aware and cannot be taken to be aware that the funds representing its UPE are being used for the potential benefit of any or all discretionary objects of the trust (rather than being physically set aside or used for its sole benefit).

The ATO has appropriately consulted with Treasury prior to and during the drafting of TR 2009/D8.

Provisions within Division 7A dealing with unpaid present entitlements will continue to have their intended application and there is no inconsistency between the Exposure Draft legislation and the draft Ruling.

Use of assets

5.7 As was announced in the 2009/10 Federal Budget the use of assets owned by private companies, or owned by trusts where there is a present entitlement owing to a private company may be subject to tax after 1 July 2009.

5.8 The way in which the use of assets will become subject to tax is through the amendment of the definition of the term 'payment' in Division 7A so that it extends to the provision of an asset (other than a transfer of property) for use by an entity. Consistent with the present operation of Division 7A the provision of the asset will only result in Division 7A consequences where the asset is provided to a shareholder or associate of a shareholder.

5.9 For the purposes of Division 7A the payment will occur when the use of the asset occurs.

5.10 A payment will also arise however where the asset is not used, but is available for use. The examples in the EM are illustrative of when it will be the right to use the asset, and not its use, that is subject to the Division 7A rules.

> ***Example (right to use from EM)***
> ***Brian is a shareholder of a private company that owns a luxury yacht. He does not have a formal agreement with the company in relation to the yacht, however, he takes the yacht out every second weekend.***
>
> ***Brian keeps the yacht at the company's business premises, but takes the key home. Brian stores several personal items on the yacht.***
>
> ***Brian's fortnightly use of the yacht is a payment under Division 7A. The availability of the yacht for Brian's use is also subject to Division 7A because the yacht is not readily available for use by the company. The company would need to arrange with Brian to***

get the key and for the removal of Brian's personal items before using the yacht. That is, the asset is available for Brian's use to the exclusion of the company.

Example (use from EM)
Marina is a shareholder of a private company that owns a city apartment. The apartment is generally available for rent. However, Marina asks the company not to rent the apartment out for a week so that she and her family can use the apartment over a long weekend. Marina's use of the apartment is a payment for the purposes of section 109CA.

5.11 An issue that arose on consultation over the draft legislation giving effect to these changes was whether the mere availability of assets to a shareholder or associate would result in the shareholder or associate being treated as having the asset available for their use. The EM again includes an example where there a payment is not taken to arise where an asset is available as a result of a general entitlement to use an asset without actual use of the asset.

Example (mere entitlement from EM)
Peter is a shareholder of a private company that owns five cars for company use. Shareholders and their associates have general permission to use the cars on weekends if they are not being used for company business. Peter regularly takes one of the cars home.

Peter's use of the car that he takes home will be subject to Division 7A. This will include driving the car (actual use) and the availability of the car for his use to the exclusion of the company, such as when it is parked at home, or at a restaurant that Peter is visiting.

Although Peter may have general permission to use all five of the cars, he does not use all of them for the purposes of Division 7A. The four cars that Peter leaves at the company premises are available for the company to loan to another shareholder, employee, customer, or other party. That is, these cars are not available to Peter to the exclusion of the company.

5.12 The EM also includes examples of where an asset is available to more than one shareholder or associate and it is necessary to determine who is taxed. The EM suggests and apportionment of the taxable value to the person who is the real recipient of the benefit. One example sets out that a minor that benefits should not be taken to receive a Division 7A payment, where another sets out that incidental use by a spouse of a vehicle provided to a shareholder would not result in the spouse being taxed on the benefit provided.

5.13 In valuing the payment taken to be made it will be the amount that would have been paid for the use of the asset in an arm's length dealing less any consideration paid that will be determined to be the payment for Division 7A purposes.

5.14 There are a number of exceptions from the payment provisions applying, including one not previously announced dealing with residential property:

5.14.1 Minor benefits – if the provision of the asset would have been a minor benefit under section 58P of the FBTAA had it been provided to an employee then the benefit will be disregarded for Division 7A purposes

5.14.2 Otherwise deductible payments – if a once off deduction would have been available to the shareholder or their associate in connection with the use of the asset then there will be no benefit to be taken into account for Division 7A purposes.

5.14.3 Dwellings – the use of a dwelling can be exempt where the following conditions are satisfied:

5.14.3.1 the entity or their associate is carrying on a business;

5.14.3.2 the entity or their associate uses or is granted or has a lease, licence or other right to use land, water or a building for the purpose of carrying on the business; and

5.14.3.3 the provision of the dwelling to the entity is connected with that use or with that lease, licence or other right to use the land, water or building to carry on the business.

5.14.4 Main residences – the provision of a dwelling that is a person's main residence does not result in a Division 7A payment where:

5.14.4.1 The provider of the dwelling is a private company;

5.14.4.2 The private company acquired the dwelling before 1 July 2009; and

5.14.4.3 The private company would pass COT from the time that the dwelling was acquired until the end of the time that a payment could be taken to be made under Division 7A.

5.14.5 Vacant land – if the exception for a dwelling or a main residence applies, it will extend to adjacent land in the same way as occurs in the main residence exemption.

Corporate limited partnerships

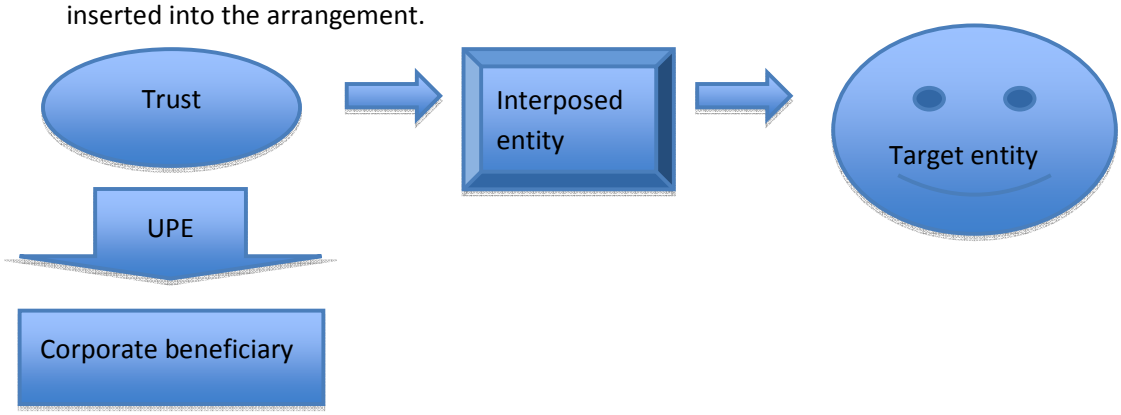
5.15 Closely held corporate limited partnerships (limited liability partnerships) will also now be subject to Division 7A. A corporate limited partnership will be closely held where it has fewer than 50 members or where an entity has, directly or indirectly, for the entity's own benefit, an entitlement to 75% or more of the income and capital of the partnership.

Interposed entities

5.16 The Div 7A Amendments fix two drafting issues in relation to the use of interposed entities.

5.17 The Division 7A legislation as originally drafted allowed for a payment by a private company through an interposed entity to be treated as a payment for Division 7A purposes.

5.18 The legislation did not however on a plain reading, allow for a trust where there was an unpaid present entitlement, to be deemed to have made a payment where an interposed entity was inserted into the arrangement.



5.19 A payment from the trust through an interposed entity to a target entity will now be caught by Division 7A if a reasonable person would consider that a loan or payment made to the interposed entity was made to enable a loan or payment to be made by the interposed entity to the target entity.

5.20 Consistent with the current operation of Subdivision EA however, a payment through to the target entity will only result in a Division 7A deemed dividend if it is referable to a reduction in a present entitlement that is in itself attributable to an unrealised gain in the trust.

5.21 The Div 7A Amendments also ensures that where an unpaid present entitlement is owed to a company by a trust, but the loan, payment or forgiveness that occurs does not involve the trust that owes the unpaid present entitlement, that Subdivision EA still has effect.

5.22 Subdivision EA will apply to treat a loan or payment from a trust as being a Division 7A loan or payment to the extent that the loan or payment is referable to an unpaid present entitlement owed to a private company where that amount has not already resulted in a Division 7A loan or payment.

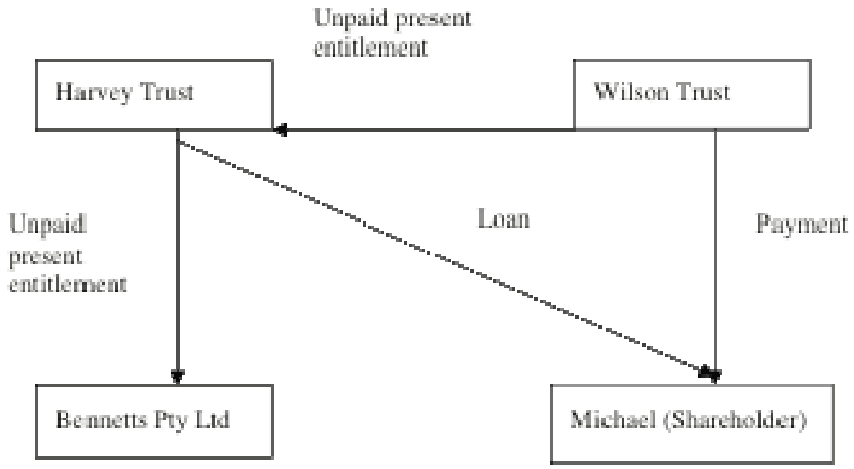
Example (interposed trust from EM)
Michael is a shareholder of Bennetts Pty Ltd and Bennetts Pty Ltd is a beneficiary of Harvey Trust. In the 2009-10 income year, Michael receives a payment from the trustee of the Wilson Trust, which is attributable to an unrealised gain. He receives this payment

because of his shareholding in Bennetts Pty Ltd. Michael also receives a $2,000 non-compliant Division 7A loan from the Harvey Trust.

Bennetts Pty Ltd is not presently entitled to an amount from the net income of the Wilson Trust. However, Bennetts Pty Ltd is entitled to $10,000 from the net income of the Harvey Trust (the first interposed trust) and Harvey Trust is presently entitled to $10,000 from the net income of the Wilson Trust. These amounts remain unpaid.

The loan made by the Harvey Trust to Michael will be included in Michael's assessable income under ordinary operation of subsection 109XA(2).

Bennetts Pty Ltd is taken to be presently entitled to $8,000 from the Wilson Trust, which is the unpaid present entitlement of $10,000 from the Harvey Trust, reduced by the $2,000 loan amount that is included in Michael's assessable income under another provision of Subdivision EA.



Loan back arrangements

5.23 Subdivision EA as currently drafted only captures payment arrangements where the payment is a reduction of a present entitlement that is referrable to an unrealised gain.

5.24 To circumvent these rules, apparently it had been suggested that the following arrangement could be entered into:

5.24.1 An unpaid present entitlement exists to a private company, say of $100,000.

5.24.2 A payment is made by the trustee of the trust to a beneficiary of an amount far in excess of the UPE, for example $1 million.

5.24.3 The amount in excess of the UPE is then loaned back to the trustee, being $900,000.

5.24.4 Thus, the beneficiary now has a credit loan of $900,000.

5.24.5 In future years the trustee appoints income to the company and uses the funds to repay the credit loan.

5.25 The need for there to be a payment referrable to a reduction of an unrealised gain will be removed where the payment made to a beneficiary is in reduction of a loan made on or after 1 July 2009 where a reasonable person would conclude that the trustee obtained the loan in order to make the payment.

Amendment to distributable surplus definition

5.26 The definition of distributable surplus will be amended so that amounts that have been deemed to be dividends as a result of the operation of Subdivision EA will be removed from the distributable surplus (by being correctly included as non-commercial loans).

Forgiveness of 109XB loans

5.27 There is a drafting problem that will be rectified so that the forgiveness of a loan by a trustee that has already been deemed to be a dividend will not result in a subsequent dividend. The law already applies in this way to the forgiveness of a debt owed to a private company by a shareholder that has already been deemed to receive a dividend under Division 7A.

Dividend set-off

5.28 Another drafting problem dealing with dividend set-offs will also be rectified.

5.29 At present, where a private company makes a loan that is deemed to be a dividend and later pays an unfranked dividend that is set off against that loan the later dividend is not included in assessable income.

5.30 The ability to disregard the later dividend does not apply where the loan was made by the trustee of a trust and where the deemed dividend arose under section 109XB.

5.31 The ability to disregard a later unfranked dividend offset against a loan from a trustee is being introduced.

Setting off employment entitlements

5.32 Another unusual aspect of the interaction of Division 7A generally and Subdivision EA has been that employment related payments that are offset against loans by trustees do not count as repayments if there is a borrowing of a similar or greater amount to the amount repaid. This is in contrast to setting off such a payment against a loan by a company where the repayment is taken into account even if there is a further borrowing.

5.33 This anomaly is to be rectified.

Borrowing to repay

5.34 Under the previous law a repayment is disregarded where the repayment is made where a reasonable person would conclude the repayment was made in order to borrow a similar or greater amount. This prevents a person from borrowing funds during a financial year, repaying on 30 June, and then reborrowing the amount on 1 July.

5.35 While the law has operated in this way (with some exceptions for repayments that occur by way of offsetting assessable amounts such as the wages noted above) it arguably has not operated where, instead of repaying to borrow, a person borrows to repay. This was be remedied so that a borrowing to repay will also activate section 109R.

> ***Example (from EM)***
> ***Alicia obtains a loan of $10,000 from Cleary Pty Ltd. Alicia has until the lodgment day to repay the loan. Two weeks before the lodgment day Alicia obtains a further $10,000 from Cleary Pty Ltd. She then repays the original $10,000 loan a week before the lodgment day.***
>
> ***The repayment of the original $10,000 loan is not a repayment for the purposes of section 109D, because Alicia has borrowed a similar amount from Cleary Pty Ltd and in this case a reasonable person would conclude that the loan was obtained in order to make the repayment of the original $10,000.***
>
> ***The original $10,000 loan is treated as a deemed dividend subject to the distributable surplus of the private company.***

Adding back payments for Division 7A purposes

6. Streaming

6.1 The paper will no consider the importance of, and ability to, stream as it stood before the Streaming Amendments. Then it will consider the Streaming Amendments.

Pre-Streaming Amendments

6.2 As can be seen from the illustrations above the ability to stream income according to its character is very important. This is particularly the case for franked dividends and capital gains but there are other forms of income with tax characteristics that may also be important e.g. income from a foreign source, income which has been subject to TFN withholding tax.

6.3 The decisions in Bamford tell us nothing about streaming income for tax purposes.

6.4 Most modern trust deeds will give the trustee power to distinguish between classes of income and to characterise a particular amount of income as having been derived from a particular source. The Deed should also allow the trustee to allocate expenses to the different classes of income.

6.5 The law regarding streaming after the decision in *CPT Custodian Pty Ltd v Commissioner of State Revenue [2005] HCA 53* ("**CPT Custodian**") was quite uncertain. The decision of the High Court in *Charles v C of T [1954] HCA 16* ("**Charles**") has always been the centre of gravity of the character flow through approach. The decision in Charles was heavily criticised by the Court in CPT Custodian. The question is whether that criticism went to the maintenance of character or is restricted to the characterisation of the interest in the trust fund by looking through to the underlying assets.

6.6 The decision of the High Court in CPT Custodian, in the writers' views, stands for the proposition that a beneficiary has an equitable interest in the residue of the trust fund after the Trustee's indemnity has been satisfied. This residue is characterless, whether it be income or capital, as the trustee may at any time satisfy its right to be indemnified from the receipts (which themselves have character).

6.7 Notwithstanding these problems the ATO has consistently taken the view that the character of the income in the hands of the beneficiary is taken from the character of the receipts of the Trustee[4] even after taking into account the decision in *CPT Custodian*[5].

6.8 In the non-binding ruling IT2328 (now withdrawn) it was observed:

> *"For income tax purposes where a beneficiary in a trust estate is presently entitled to the net income or a share of the net income of the trust estate, that income as a general principle has the same character in the hands of the beneficiary as it had in the hands of the trustee."*

6.9 The most significant streaming issues concern capital gains and dividends. In the case of capital gains Division 115 of Part 3-1 of the 1997 Act proceeds on an implication that income entitlements will take on at least some part of the character of the capital gains derived by the trustee. There is no clear legislative follow through. The guidance found in Sesction 115-200 of the 1997 Act establishes the implied maintenance of character:

> *"This Subdivision sets out rules for dealing with the net income of a trust that has a net capital gain. The rules treat parts of the net income attributable to the trust's net capital gain as capital gains made by the beneficiary entitled to those parts."*

[4] see in particular ATO ID 2008/51 dealing with Division 13.3A of the SIS Regulations.

[5] see Taxation Ruling STR 92/13, IT2328, IT2512, IT2004 (withdrawn) and ATO ID 2007/108 (which is concerned with foreign sourced income and in respect of which subsection 6B(2A) of the 1936 Act also comes into consideration).

6.10 Subsection 115-215(1) is the nub of the provisions:

> *"The purpose of this section is to ensure that appropriate amounts of the trust estate's net income attributable to the trust estate's capital gains are treated as a beneficiary's capital gains when assessing the beneficiary, so:*
>
> *(a) the beneficiary can apply capital losses against gains; and*
>
> *(b) the beneficiary can apply the appropriate discount percentage (if any) to gains."*

6.11 The process is described as attribution rather than maintenance of source character. This may be the necessary distinction to make the rules work. There is, however, no guidance about how the attribution is to be carried out.

6.12 What is clear is that if there is no trust income to which the beneficiary is presently entitled there can be no attribution. This is a major issue where there is no trading income but there are capital gains in the Trust. Use of s 95(1) terms to describe income overcomes this problem and makes the case for attribution much clearer. The capital gain (or at least 50% of it) will be included in the income. The connection for Subdivision 115-C purposes is very clear.

6.13 The ATO has had to resort to the artificiality of the "capital beneficiary approach" in PS LA 2005/1 (GA) to achieve this sensible outcome – but this practice statement was withdrawn following Bamford.

6.14 The issues with streaming can be readily appreciated in the context of capital gains and the 50% general CGT discount. The streaming issue is, of course, the denial of the 50% CGT general discount when a trust to company distribution is in play.

6.15 Maintaining the example used above in which there is a net capital gain of $100,000, and gross rental income of $50,0000 and net rental income of $20,000.

6.16 In this instance the trustee wishes to cause the capital gain to be assessed in the hands of an individual (say Mrs A) and the net rental income in the hands of a company, A Co. If it is assumed that the Trust Deed has all of the usual income characterisation and streaming provisions and the Deed adopts subsection 95(1) terms, the outcome readily appears.

6.17 The income entitlements are:

	$	
A Co	20,000	comprising net rental income
Mrs A	50,000	comprising the capital gain
	70,000	

6.18 If the ATO took the view that streaming was unobtainable the outcome would be:

	$	$ Total
A Co	5,714 + taxable capital gain $28,572	34,286
Mrs A	50,000	50,000
		84,286

6.19 The other area of concern is franking credits. At least there is a ruling on this aspect of streaming, *Taxation Ruling* 92/13 (repealed as of 22 June 2011 because of the Streaming Amendments). The provisions of Subdivision 207-B and in particular ss 207-45 to 207-57 are consistent with flow through of the franked character of a dividend.

6.20 The fact the Example set out immediately below s 207-35(3) of the 1997 Act depends on character maintenance. It is worthwhile setting this Example out in full:

> *"A franked distribution of $70 is made to the trustee of a trust in an income year. The trust also has $100 of assessable income from other sources. Under subsection (1) the trust's assessable income includes an additional amount of $30 (which is the franking credit on the distribution). The trust has a net income of $200 for that income year.*
>
> *There are 2 beneficiaries of the trust, P and Q, who are presently entitled to the trust's income. Under the trust deed, P is entitled to all of the franked distribution and Q is entitled to all other income.*
>
> *The distribution flows indirectly to P (as P is entitled to a share of that net income and has a 100% share of the distribution under section 207-55). P therefore has an amount of assessable income that is equal to its share of the distribution. Under this subsection, P's assessable income also includes the full amount of the franking credit (as P's share of the franking credit on the distribution is $30 under section 207-57). Q's share of the net income therefore does not include any of the franking credit."*

6.21 Clearly the legislation contemplates maintenance of character for the purposes of dividend imputation.

Commissioner's Concern of Division 6 Abuses

6.22 As usual the ATO is driven by the possibility that the decision in Bamford might support some abuse and revenue loss. No matter that their interpretations lead to massive headaches for practitioners.

6.23 This much is exampled by several examples set out *in Practice Statement PS LA 2009/7* which was released prior to the decision in Bamford.

6.24 Examples 1 and 5 in particular show what the ATO is on about.

6.25 Example 1 concerns the trustee of a family trust deriving $250,000 in income during the income year and applying that income to the purchase of a holiday home. The trustee, acting in accordance with a power expressed in the terms of the Trust Deed to do so, determines that the expenditure on the purchase of the house is an outgoing on income account with the effect that the trust law income available for distribution is $5,000. One of the beneficiaries has tax losses.

6.26 The trustee distributes the $5,000 trust law income to the loss beneficiary. The losses cover the tax law income which follows the trust law income to the loss beneficiary.

6.27 The ATO expresses concern about the mismatch of the actual amount to which the beneficiary becomes entitled ($5,000) and the amount of the tax law income flowing to the beneficiary ($250,000) and the tax not paid because of the losses.

6.28 It is difficult to say why this is of concern to them. The true effect of the transaction is to maintain $245,000 in the capital of the trust. The same tax effect would be obtained by distributing all of the $250,000 to the loss beneficiary. There is no tax difference in this illustration. It is unlikely there would be a tax benefit for the purposes of Part IVA. The most likely explanation for the transaction is the financial risk the loss beneficiary has been exposed to. If the beneficiary became entitled to call on the trustee to pay him or her $250,000 the creditors may be able to stake a claim to that amount. It is a neat and sensible piece of asset protection planning.

6.29 Example 5 is about a trust which has distinct income and capital beneficiaries. The trustee has a power to determine whether receipts and outgoings are on income or capital account. The Trust Deed is amended to admit a tax exempt entity as a beneficiary.

6.30 The trust derives $100,000 of income (meaning income according to ordinary concepts) during the income year. The trustee determines that $95,000 of that amount is a capital receipt. The remaining $5,000 is the trust law income according to the Trust Deed. This amount is appointed to the tax exempt beneficiary. All of the tax law income will be assessed to the charity. It would follow that the trustee makes a capital distribution of the $95,000 to a family beneficiary.

6.31 The ATO observe in the Practice Statement that Part IVA might apply in the circumstances. In the writer's view it almost certainly would do so in particular because of the amendment to introduce the tax exempt charity as a beneficiary and the fact that prior year distributions had been made only to family members. A much more challenging (and perhaps more realistic) illustration would arise if the tax exempt charity was already an object and the trustee had made distributions to charities in the past. The Part IVA case in such circumstances would be difficult to make out. This is an example of the acknowledged "apparent unfairness in the resulting administration of the legislation" as noted by the High Court in Bamford at [17].

6.32 The ATO apparently accept that Bamford authorizes characterization of capital receipts as income for the purposes of the Deed but are not so ready to accept that ordinary income may be recharacterised as capital (as in Example 5). They appear to be fortified in this by observations made by the Full Court of the Federal Court in *Forrest v C of T* [2010] FCAFC 6 ("**Forrest**").

6.33 The relevant question before the Court there was whether Mr Forrest was entitled to a deduction for interest he had incurred in relation to funds he had borrowed to acquire units in a unit trust. The outcome turned on whether there was a fixed income component to which the funds related. The Full Court concluded that a power to determine whether any amount received by the trustee was on revenue account or capital account (clause 12 of the Deed) was not a power to change the beneficiaries' rights. In so doing they observed at [11]-[12]:

> *'In our opinion, the power conferred by cl. 12 cannot be exercised by the trustee wrongly to classify a receipt as a capital gain, when the receipt is, in truth, income, and thus deprive the appellant of his interest in the unit component of the trust. Clause 12 is not an unlimited power to be exercised in the trustee's unconfined discretion….*
>
> *Clause 12.2(a) is a power to determine how a distribution to beneficiaries is classified. That limited power is not a power which is capable of altering the beneficiaries' rights. Clause 12 is to be read consistently with the balance of the Trust Deed and an appreciation that it contains various powers of an administrative character. The words used can be given full force honestly to classify income or distributions according to law, as the appellant contended to this Court".*

6.34 It is very difficult to know how far this goes. The issue in Forrest was about whether or not the exercise of the power changed the rights as between classes of beneficiaries. Presumably the ATO would say that the exercise of the power in a case like that in Example 5 was not an "honest" classification of the receipt as capital. Hopefully the issue will not arise very often.

Point of Interest

6.35 A case of interest is *Greenhatch v FCT* [2011] AATA 479 that ostensibly concerned superannuation contributions where the answer to the superannuation question was determined by construing streaming through a trust. The case of is interest for two reasons.

6.36 First, the AAT went out of their way to note the Commissioner's interpretation of Bamford was wrong. At [49] and [50] they said:

> *Much, if not all, of the Commissioner's case turns on his rejection of any underlying conduit theory and his interpretation of the implications of the decision in Bamford.*

The Commissioner's contention that the conduit theory has no role to play is based on foundations with which we do not agree. Accordingly, those foundations do not support the conclusion he seeks to draw.

6.37 Secondly, in relation to Subdivision 207-B of the 1997 Act, being the franking credits provisions, the AAT observed at [63]:

> *Section 207-35 of the 1997 Act has an aspect that makes the conclusion [that] amounts passing through trusts to beneficiaries thereof carry the character and identity that they had in the hands of the trustee more compelling. That section includes an example that contemplates differential distributions in determining the taxation burdens that are imposed on the beneficiaries of the trust.*

6.38 Question: was it necessary to introduce the Streaming Amendments in light of the above comments? Given we have the Streaming Amendments it is of academic interest only.

Streaming Amendments

6.39 The *Tax Laws Amendment (2011 Measures No. 5) Act* 2011 (Cth) was introduced into parliament (as a Bill) on 2 June 2011, was passed unamended and assented to on 29 June 2011. They take effect from 1 July 2010. These dates show how close a call it was as the Streaming Amendments are critical for trustee decisions that were needed to be made on 30 June 2011 – one day after their royal assent.

6.40 Subject to a statement by the Commissioner – extending the time a trustee could make decisions to 31 August 2011, which has anyway passed, but the writers question the Commissioner's ability to alter what trust law[6] requires to be done on 30 June of any year – the Streaming Amendments apply to trustees resolving to deal with trust income and capital gains.

6.41 From the 2011 income year and thereafter taxable capital gains and franked distributions are dealt with under these rules.

6.42 The Streaming Amendments operate by diverting from Division 6 of the 1936 Act the franked distributions and taxable capital gains. They are assessed directly in the hands of the beneficiaries who are presently entitled to them. They do this via Subdivision 207-B of the 1997 Act for franked distributions and via Subdivision 115-C of the 1997 Act for taxable capital gains. However, for the taxable capital gains they must still pass through the method statement in s 102-5(1) of the 1997 Act.

[6] *Trustees of the Estate Mortgage Fighting Fund Trust v FCT* [2000] FCA 981 per Hill J; *Case R105,* 84 ATC 692; *Antonopoulos v FCT* [2011] AATA 431.

6.43 The Streaming Amendments have introduced a new Division 6E into Part III of the 1936 Act to prevent double taxation. It adjusts the Division 6 income and net income of the trust to take out the amounts to which the beneficiary has been made specifically entitled.

6.44 It can be seen that the specific entitlement of the beneficiary or beneficiaries is the critical aspect of the Streaming Amendments. This is required to determine tax liability.

Specific Entitlement

6.45 The notion of a specific entitlement conceals the difficulties of applying the Streaming Amendments to all trusts, be they discretionary, fixed, unit, et cetera. The mechanism by which you become specifically entitled are set out in the relevant Subdivisions: s 115-228 for capital gains and s 207-58 for franked distributions. The provisions seem substantially similar at first look but there are some significant differences.

6.46 A beneficiary is specifically entitled under s 207-58 of the 1997 Act to an amount of a franked distribution made by the trust equal to the amount calculated under the following formula

$$\text{Franked Distribution} \times \frac{\text{Share of net financial benefit}}{\text{Net financial benefit}}$$

6.47 The "net financial benefit" is an amount equal to the financial benefit referable to the franked distribution (after an application by the trustee of expenses that are directly relevant to the franked distribution).

6.48 The term "financial benefit" is already in s 995-1 f the 1997 Act. It means anything of economic value, even if the transaction also imposes an obligation on the entity. Benefits and obligations are to be looked at separately and not set off against each other, but it is the net financial benefit to which the formula looks.

6.49 The "share of the financial benefit" is the amount of the financial benefit referable to the franked distribution specifically linked to the particular beneficiary. The share of the net financial benefit is:

> *… an amount equal to the *financial benefit that, in accordance with the terms of the trust:*
>
> *a. the beneficiary has received, or can be reasonably expected to receive, and*
>
> *b. is referable to the *franked distribution (after application by the trustee of any expenses that are directly relevant to the franked distribution) and*
>
> *c. is recorded, in its character as referable to the franked distribution, in the accounts or records of the trust no later than the end of the income year.*

6.50 Section 115-228 is identical to the discussion above of franked distributions, subject to:

6.50.1 the financial benefit must be referable to the capital gain "after application by the trustee of any losses, to the extent that the application is consistent with the application of capital losses against the capital gain in accordance with the method statement in subsection 102-5(1)"; and

6.50.2 the recording of the financial benefit must be "no later than 2 months after the end of the income year."

Complexities and Going Forward

6.51 An issue to be mindful of is – in fact an issue of significant importance – is that a trust with no "income", which was one of the problems in the Bamford appeals, will not be able to stream franking credits. This will mean that where the franked distributions, together with other ordinary income, is insufficient to more than offset expenses of the trust the franking credits cannot go through to the beneficiaries. The same restriction does not apply in relation to capital gains streamed through the trust.

6.52 Ken Schurgott FTIA, in his paper in the August 2011 *Taxation in Australia* titled "Trust streaming 2011" notes a number of complications that arise from the Streaming Amendments:

> *As will be seen, there are a number of issues which emerge that complicate the legislation over and beyond the rather simple approach adopted prior to the Commissioner's stance on streaming. The things which complicate matters are:*
>
> *a. There can be different outcomes according to the definition of income adopted by the trust deed;*
>
> *b. Significantly different outcomes can result where a beneficiary has not been made specifically entitled to the franked distribution or capital gain. This is most pronounced in relation to capital gains;*
>
> *c. The concept of making a beneficiary entitled to the entire financial benefit from a capital gain or franked distribution is fraught with difficulty, particularly where there are capital losses or directly related expenses; and*
>
> *d. The way in which capital losses and directly related expenses are to be dealt with is confusing.*

6.53 It can be seen from these further issues, and the problem of actually apply what is a simple concept of diverting the amounts to Subdivisions 115-C and 207-B respectively, are anything but straightforward or settled. Indeed, a senior council on the writer's floor, after having advised on

the Streaming Amendments is of the view that this is where future archeologists will find the bones of 21st Century tax lawyers and accountants.

7. Changes to the taxation of trusts – terms to be provided for in a trust document

7.1 Given the changes in the taxation of trusts, it is recommended that trust deed (or any other constituent documents) be reviewed so as to determine:

7.1.1 How income, capital gains and outgoings are accounted for and determined; and

7.1.2 How income, capital gains and outgoings are to be distributed.

7.2 Some of the powers which may be advantageous to have within a trust instrument include:

7.2.1 an accounting policy which is sufficiently broad and allows the trustee to exercise maximum discretion;

7.2.2 the discretion to reclassify and allocate income and capital gains;

7.2.3 the discretion to reclassify and allocate outgoings;

7.2.4 the discretion not to recoup losses (whether income or capital in nature);

7.2.5 the ability to allocate and stream classes of income and capital and their related tax attributes;

7.2.6 and ensure that any unpaid present entitlement / loan provisions are removed, and an ability to hold amounts subject to a sub-trust.

7.3 Some additional powers to be considered include:

7.3.1 whether the trustee has the power to distribute income and / or capital at any time within a tax year;

7.3.2 whether any determination of income (or capital) can be made within the income tax year; and

7.3.3 whether the trustee has a power to determine entitlements with respect to an income tax year after the relevant year.

Accounting policy

7.4 Essential is ensuring that the trust deed provides guidance with respect to an accounting policy that should be used by the trustee. Such an accounting policy should provide sufficient flexibility for the trustee, so that it may depart from generally accepted accounting standards in the event that the trustee considers that it is appropriate to do so.

Reclassifying and allocating income and capital

7.5 As the High Court in *Bamford* accepted that the tax law income of a trust is dependent upon (amongst other things) the definition of that term in the trust deed, regard should be given to the definition of the 'income' as contained in the trusts constituent documents.

7.6 An issue to consider is whether attributed amounts (e.g. franking credits) should be included within the definition of trust income. An issue that arises is that if attributions are included in trust income (and which are not physically 'paid' by a trustee – but which follow certain amounts of income), whether by being included in trust income, and thereby providing that a trustee creates a 'present entitlement' in a beneficiary to an amount that is never received by a trustee, the trustee will be exposed to a claim in relation to amounts that are not actually received by the trustee.

7.7 It is submitted that amounts such as franking credits should be prima facie carved-out of the definition of income. However, the definition should contain discretionary elements to allow a trustee to cause such 'attributed' amounts to fall within the definition of income.

7.8 An approach which may be considered is, in defining trust income:

7.8.1 Provide that it prima facie equals the amount provided for in s 95(1) of the 1936 Act (less any franking credits);

7.8.2 If the tax law approach is not warranted for a particular tax period, then:

7.8.2.1 According to an accounting policy adopted by the trustee; or

7.8.2.2 Any other basis as determined by the trustee; or

7.8.3 In the trustee's absolute discretion, the gross income of the trust.

Reclassifying and allocating outgoings

7.9 In *Cajkusic v FC of T (No 2)* (2006) ATC 4752 ("**Cajkusic**") deductions allowable to a family discretionary trust for payments that were made under an employee benefits trust arrangement in the income tax years ending 30 June 1997 and 30 June 2008 caused there to be a loss within the trust estate.

7.10 As a result of the losses, there was no distributable income of the trust. As a result, the Full Court of the Federal Court held that the lack of distributable income meant that there could be no beneficiary of the trust (for the relevant income tax years) to be "*… presently entitled …*'"pursuant to s 97 of the 1936 Act to any amount.

7.11 It should be noted that the Commissioner's subsequent application for special leave to appeal to the High Court was rejected.

7.12 Cajkusic stands for the proposition that the 'distributable income' of a trust is determined by reference to proper accounting principles, as well as the terms of a trust deed. In this context distributable income is income determined according to accounting principles, and which is distributable amongst the beneficiaries. It does not alter either the income as calculated under accounting principles, of the 'net income' as determined under s 95(1) of the 1936 Act – rather, only gives a trustee the power to determine the distributable amounts.

7.13 As a result of the decision in Cajkusic, it is submitted that a trust deed should give a trustee the power to reclassify, and allocate outgoings, so that there can be 'distributable income' to which beneficiaries are presently entitled.

Discretion not to recoup losses (whether income or capital in nature)

7.14 It is recommended that a trustee have a discretion not to recoup losses (whether of an income or capital nature). That is, a power not to recoup losses which have arisen in the past.

8. Resettlement considerations

8.1 Whenever the terms of a trust are varied, an issue to consider is whether the variation amounts to a 'resettlement'.

8.2 Resettlements relate to changes to a trust relationship which have the effect that a new trust estate comes into existence. According to the High Court in *FC of T v Commercial Nominees of Australia Ltd* [2001] HCA 33 (***"*Commercial Nominees"**), the issue to determine is whether '*… what occurred* … [i.e. the variation] … *was a fundamental alteration in the trust relationship*

established by the original deed, such that it destroyed the necessary continuity of the 'taxpayer'…'.

8.3 A resettlement can have significant income tax, capital gains tax (**'CGT'**) and stamp duty consequences, including that:

8.3.1 the trust property may be disposed of, potentially triggering both stamp duty and CGT liabilities;

8.3.2 carried forward tax benefits may be lost; and

8.3.3 beneficiaries may dispose of their interests in the original trust and acquire interest in a new trust.

8.4 Specifically in the context of CGT, a resettlement may cause either CGT event E1 (s 104-60 of the 1997 Act) or CGT event E2 (s 104-65 of the 1997 Act) to happen.

8.5 In August 2001 the issued a Statement of Principles entitled *Creation of a new trust* (the **"Statement**"). The Statement clarifies when, in the Commissioner's view, changes to a trust gives rise to a new trust. The Commissioner considers that a new trust estate arises where there is a 'fundamental change to a trust relationship' – ie, a change in the essential nature and character of the original trust relationship. Further, the Commissioner considers that a new trust (i.e. a resettlement) may arise in the following circumstances:

- a change in beneficial interest in trust property;
- a new class of beneficial interest (whether introduced or altered);
- a redefinition of the beneficiary class;
- changes in the terms of the trust or the rights or obligations of the trustee;
- changes in the nature of the trust property;
- additions of property which could amount to a new and separate settlement;
- depletion of trust property;
- a change in the termination date of the trust;
- a change in the trust that is not contemplated by the terms of the original trust;

- a change in the essential nature and purpose of the trust; and / or
- a merger of two or more trusts or a splitting of the trust.

8.6 The Commissioner considers that depending on their nature and extent, the above changes may either amount to:

8.6.1 a variation of a continuing trust; or

8.6.2 a fundamental change in the essential nature and character of the trust relationship. In such a case, the original trust may be brought to an end and a new trust created. Whether a new trust is created depends on the terms of the original trust and on the powers of the trustee.

8.7 The High Court in Commercial Nominees held that significant changes to a superannuation fund trust deed did not create a new trust, even though the amending deed had:

8.7.1 changed the name of, and appointed a new trustee to the fund;

8.7.2 introduced a new category of beneficiaries;

8.7.3 changed the fund from a defined benefit fund to an accumulation fund;

8.7.4 appointed a professional management company as administrator; and

8.7.5 allowed membership to be promoted to the public.

8.8 The High Court in *Commercial Nominees* considered that there were three main indicators of the continuity of a trust relationship, being:

8.8.1 the constitution of the trust;

8.8.2 the trust property; and

8.8.3 the membership of the trust.

8.9 Substantial changes any of the above may cause a resettlement.

8.10 The High Court considered that, in order to destroy the necessary continuity, changes in one or more of the above indicators must be such as to terminate the existence of the entity, or to produce the result that the particular trust does not derive the income in question. It was held that the changes made to the trust deed in question were not sufficient to destroy the continuity, primarily because the fund was at all times governed by the same deed, the trust property did not change, and the members before the amendment to the trust deed remained members afterwards. We consider that the amendments discussed above will not cause a resettlement.

8.11 The Commissioner notes in the Statement that administrative changes, such as re-defining trust income (without more) may not cause a resettlement (depending on the context) as it may be administrative in nature.

8.12 However, regard will need to be given to the implications to the membership (i.e. the beneficial entitlements) of the trust, and what implications such an amendment will have on the respective entitlements in a trust. For example, an important consideration will be determining how unallocated / undistributed income is to be dealt with. For example, is such income:

8.12.1 accumulated, and form part of the corpus of the relevant trust estate;

8.12.2 is it distributed to certain default beneficiaries; or

8.12.3 is it held on trust for a specific purpose (e.g. a charitable purpose).

Changes in the Taxation of Trusts

A paper presented by Michael Bennett and Denis Barlin at the NSW Young Lawyers CLE

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Michael Bennett E bennett@sevenwentworth.com.au D 8224 3055 M 0408 029 416
Denis Barlin E dbarlin@wenworthchambers.com.au D 9231 6646 M 0404 848 311

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1. General overview

1.1 The income years ended 30 June 2010 and, more particularly, 30 June 2011 have been very active for the taxation of trusts. Significant events in three areas of trust taxplay activity:

1.1.1 decisions of the Courts and principally the High Court's decision in *Commissioner of Taxation v Bamford* (2010) 240 CLR 481; (2010) 264 ALR 436; [2010] HCA 10 ("**Bamford**");

1.1.2 legislative changes, principally:

1.1.2.1 the new rules set out in *Tax Laws Amendment (2011 Measures No. 5) Act* 2011 (Cth) (the "**Streaming Amendments**") that deal with taxation of franking credits and capital gains in trusts; and

1.1.2.2 the new rules set out in the *Tax Laws Amendment (2010 Measures No. 2) Act* 2010 (Cth) that are principally about Division 7A of Part III of the *Income Tax Assessment Act* 1936 (Cth) (the "**1936 Act**") and companies providing rights to use property, but also contain some trust issues (the "**Div 7A Amendments**"); and

1.1.3 Australian Taxation Office ("**ATO**") activities principally the very controversial draft ruling on unpaid present entitlements, TR 2009/D8.

1.2 Some of these changes have overtaken themselves. For instance, there was at the time – and this paper includes – a discussion of streaming post Bamford (see **heading 4** below). That discussion should be read as having been overtaken by the Streaming Amendments (see **heading 5**).

1.3 And what's more the change is not over. Chapter 2 of the explanatory memorandum to the Bill that introduced the Steaming Amendments makes it clear that the streaming provisions have been introduced as an interim measure to deal with perceived anomalies in the taxation of capital gains and franked distributions pending a comprehensive review of Division 6 of Part II of the 1936 Act.

1.4 The changes made so far give rise to issues themselves and further consequential issues for trusts. In addressing the issues – both outlined above and the consequential issues – this paper will discuss:

1.4.1 Taxation of trusts generally;

1.4.2 The competing views before Bamford;

1.4.3 The context of Bamford and what it means for trusts;

1.4.4 Briefly (as it is not germane to the other issues raised in the paper) what are the Div 7A Amendments and what they mean for trusts;

1.4.5 What are the Steaming Amendments and what they mean for trust;

1.4.6 What a trust deed needs in light of those three issues; and

1.4.7 Amending trust deeds to deal with those three issues.

1.5 The issues are dealt with in this order as they are chronological to their occurring.

2. Taxation of Trusts

2.1 The provisions dealing with the taxation of trust income are contained in Division 6 of Part III of the 1936 Act (which comprises of sections 95 to 102).

2.2 As a result of the enactment of Streaming Amendments, regard should also be given to:

2.2.1 Subdivision 207-B of the *Income Tax Assessment Act* 1997 (Cth) (the "**1997 Act**") – which deals with franking credits obtained by a trust estate; and

2.2.2 Subdivision 115-C of the 1997 Act – which deals with the distribution of capital gains by a trust estate.

2.3 Chief Justice Latham in *Tindal v FC of T* (1946) 72 CLR 608 at 618 observed that the object of Division 6 of the 1936 Act is to "*… secure payment of tax upon the whole of the net income of a trust estate, either from a beneficiary or the trustee, whether the income is paid over to or on account of the beneficiary …*". Further, according to Emmett J in *Bamford v Federal Commissioner of Taxation* (2009) 176 FCR 250 "*… an important assumption underlying Division 6 …* [is] *… that a beneficiary who derives a share of the net income should be in a position to pay out of that income; otherwise, the beneficiary could be placed in a difficult position*."

2.4 The starting point in determining the taxation of trust income is s 97 of the 1936 Act. Relevantly, s 97(1) of the 1936 Act 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; and

(b) the exempt income of the beneficiary shall include:

(i) so much of the individual interest of the beneficiary in the exempt income of the trust estate as is attributable to a period when the beneficiary was a resident; and

(ii) so much of the individual interest of the beneficiary in the exempt 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;

except to the extent to which the exempt income to which that individual interest relates was taken into account in calculating the net income of the trust estate; and

(c) the non-assessable non-exempt income of the beneficiary shall include:

(i) so much of the individual interest of the beneficiary in the non-assessable non-exempt income of the trust estate as is attributable to a period when the beneficiary was a resident; and

(ii) so much of the individual interest of the beneficiary in the non-assessable non-exempt 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]

2.5 That is, s 97 of the 1936 Act provides that where a beneficiary, who is not under a legal disability is presently entitled to a "*… share of the income of the trust estate …*", the assessable income of:

2.5.1 a resident beneficiary includes the beneficiary's share of the '*… net income of the trust estate …*'; and

2.5.2 a non-resident beneficiary includes so much of the beneficiary's share of the net income of the trust as is attributable to sources in Australia.

2.6 It should be noted that the term "net income of the trust estate" for the purposes of s 97 of the 1936 Act is defined in s 95(1) of the 1936 Act. However, the term "*… the income of the trust estate …*" as contained in s 97 of the 1936 Act is not defined in the 1936 Act.

2.7 Subsection 95(1) of the 1936 Act defines the term 'net income', in relation to a trust estate as:

> ***net income**, 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 Division 393 of the Income Tax Assessment Act 1997 (Farm management deposits) 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.*

2.8 For completeness, it should be noted that:

2.8.1 s 98 of the 1936 Act provides that the trustee is liable to tax on behalf of a beneficiary where the beneficiary is presently entitled to a share of the income of a trust estate, but the beneficiary is under a legal disability;

2.8.2 ss 99 and 99A of the 1936 Act apply to subject the trustee to tax where there is some part of the net income of a trust estate that is not subject to tax under either of ss 97 or 98 of the 1936 Act. The difference as between s 99 and s 99A of the 1936 Act is the rate of tax applicable. Typically, the trustee will be subject to tax under section 99A of the 1936 Act at a penal rate of tax equal to the maximum rate of tax (currently 45%). However, the Commissioner has a discretion to apply s 99 of the 1936 Act in certain circumstances, in which case the trustee will be subject to tax at the normal marginal rates of tax.

3. The two competing views before the decision in Bamford

3.1 There has been, for some time, two competing views in the taxation of trust income – the proportionate view and the quantum view.

Proportionate approach

3.2 *David & Anor v FC of T* 89 ATC 4377 contains an example of the application of the proportionate approach (which according to the High Court's decision in Bamford, is the correct approach).

3.3 The proportionate view looks to the share (or proportion) of trust law income of a trust to which a beneficiary is "presently entitled", and then applies that share or proportion to the net income of a trust estate to calculate how much of the net income is to be included in the beneficiary's assessable income.

3.4 As an example, if a beneficiary is entitled to one half of the trust law income, then the beneficiary must include half of the net income in their assessable income – irrespective of whether it is more or less than the amount of the trust law income to which they are entitled.

(a) Implications if tax law income exceeds trust law income

3.5 Under this approach, a beneficiary who is "presently entitled" to trust law income may be required under s 97(1) of the 1936 Act to include in their assessable income an amount of net income which is greater than the amount of trust law income to which they are entitled, and to which has been paid or distributed to them.

3.6 That is, they may be subject to tax on amounts whish they will not receive, and are not entitled to actually receive.

3.7 This outcome seems to be contrary to the objectives of Division 6 of the 1936 Act as outlined by Emmett J in the Full Court of the Federal Court decision in *Bamford v Federal Commissioner of Taxation* (2009) 176 FCR 250 (discussed above).

(b) Implications if trust law income exceeds tax law income

3.8 However, where the net income of a trust estate for the purposes of s 95(1) of the 1936 Act is less than the trust law income, then a beneficiary who is "presently entitled" pursuant to s 97(1) of the 1936 Act will be required to include in their assessable income an amount which is less than the trust law income to which they will be entitled, and which will be paid to them.

3.9 As a result, an on the assumption that the beneficiaries are "presently entitled" to the whole of the trust law income, with the result that the whole of the "net income" of the

trust estate is included in their assessable income pursuant to s 97(1) of the 1936 Act, there can be no part of the net income to which ss 99 or 99A of the 1936 Act applies.

3.10 There is still a question as to whether, in these circumstances, the beneficiary must include the excess amount (i.e. the amount not included under s 97(1) of the 1936 Act) under some provision of the tax acts (e.g. CGT event E4 as contained in s 104-70 of the 1997 Act).

The quantum approach

3.11 The quantum approach (which is no longer good law) is based on the proposition that a beneficiary can only be presently entitled to such amount(s) of trust income as they actually receive.

3.12 Further, any part of the net income of the trust estate which exceeds the amount to which the beneficiary is presently entitled is not income to which the beneficiary is presently entitled to pursuant to s 97 of the 1936 Act, with the result that the trustee is subject to tax on it under s 99A of the 1936 Act (unless the Commissioner exercises it discretion to cause it to be subject to tax under s 99).

3.13 As with the proportionate approach, where the net income of the trust estate for s 95(1) of the 1936 Act purposes is less than the trust law income, such that the beneficiary receives an amount which is greater than the amount included in their assessable income, the question arises as to how the excess is to be taxed (if at all).

4. Bamford

4.1 Bamford was a much anticipated decision. In the view of some[1] the decision was a missed opportunity to settle an area of the trust law and tax law that has been crying out for correction: *Bamford* at [17] citing Hill J in *Davis v Federal Commissioner of Taxation* (1989) 86 ALR 195 at 230.

Background to Bamford

4.2 Mr and Mrs Bamford were beneficiaries of a discretionary trust known as the Bamford Trust (the "**Trust**"). The trustee of the Trust was P&D Bamford Enterprises Pty Ltd. Mr and Mrs Bamford were also the directors and employees of P&D Bamford Enterprises Pty Ltd.

[1] Slater QC *Taxation Trust Income After* Bamfor'ds *Case*, 26th National TIA Convention, 2-4 March 2011

4.3 During the 2000 income tax year, the Trust made a contribution to an offshore superannuation fund on behalf of Mr and Mrs Bamford. The contribution was sourced from borrowings by the corporate trustee, in its capacity as trustee of the Trust.

4.4 For the purposes of determining the "net income" of the Trust for the 2000 income tax year, the corporate trustee (in its capacity as trustee of the Trust) claimed a deduction for both the contribution made to the offshore superannuation fund, and the interest on the borrowed funds used to make the contribution. The total deduction claimed was $191,701.

4.5 After taking into account of the deductions, the "net income" of the Trust for that year was distributed to specified beneficiaries of the Trust. Included in the distribution were Mr and Mrs Bamford, who both had specified amounts distributed to them.

4.6 Specifically, for that income tax year (i.e. the 2000 income tax year), the trustee of the Trust allocated amounts to certain beneficiaries of the Trust, including a payment of $34,000 each to Mr and Mrs Bamford. However, the trustee of the Trust did not have sufficient funds to pay the full amount of $34,000, and instead paid them $33,872, being what the trustee of the Trust thought was the total remaining trust funds.

4.7 The amount initially distributed by the trustee of the Trust was $187,530.

4.8 In 2005, the Commissioner of Taxation applied the anti-avoidance provisions so as to disallow the deductions of the Trust (for the 2000 income tax year) for the superannuation contribution and the interest. As a result of the denial of the deductions, for the purposes of the 2000 income tax year the Trust's taxable income exceeded its accounting income.

4.9 The decision essentially dealt with two things:

4.9.1 whether the 'proportionate approach' applied in the event that tax law income exceeds accounting / trust income; and

4.9.2 whether the trust deed of the trust could characterise an amount of capital gains as income of the Trust.

Application of the proportionate view

4.10 As a result of the denial of the deduction, the Trust's taxable income increased by $191,000. The Commissioner issued amended income tax assessments to both Mr and Mrs Bamford. Pursuant to the assessments, the Commissioner contended that Mr and Mrs Bamford were liable to tax on the increased 'net income' of the Trust based on the proportionate share of the amount by which the taxable income of the trust exceeded the accounting income.

4.11 Indeed, the Commissioner sought to assess Mr and Mrs Bamford on an extra $34,624, on the basis that that amount represented the 'share' of the additional $191,000 as their share (i.e. 18%) of the previous amount (i.e. $187,530) actually distributed.

4.12 However, the taxpayers argued that they should only be taxed on the difference between the $33,872 which they actually received, and the specific amount of $34,000 which was originally allocated to them (i.e. an amount of $128 each).

4.13 The High Court rejected the taxpayer's argument, and in doing so applied the "proportionate approach".

4.14 The High Court took a two step approach in dealing with this issue:

4.14.1 First – the High Court held that the term "*… income of the trust estate …*" as contained in s 97(1) of the 1936 Act refers to distributable income, being income as determined by the trustee taking into account the terms of the trust (e.g. the trust deed) and appropriate accounting principles.

4.14.2 Secondly – after ascertaining the "share" of the distributable income to which a beneficiary is presently entitled, s 97(1) of the 1936 Act then requires that "*… that share of the net income of the trust estate …*" be ascertained, being the shares of the taxable income and not the distributable income.

4.15 Further, it was held that the inclusion within s 97(1) of the 1936 Act of the defined phrase "*… net income of the trust estate …*" and the undefined term "*… the income of …* [the] *… trust estate …*" indicated that these were intended to have different meanings. As a result, the term "*… the income of …* [the] *… trust estate* " had a different and defined meaning for taxation purposes.

4.16 The Court at [45] held that the analysis of Sundberg J in *Zeta Force Pty Ltd v Commissioner of Taxation* (1998) 84 FCR 70 at 74-75 should be applied:

> *The resolution of the second issue of construction is to be found in the analysis by Sundberg J in* Zeta Force Pty Ltd v Commissioner of Taxation *… . His Honour dealt with the first issue of construction to the same effect as that just explained, saying:*
>
> > *"The words 'income of the trust estate' in the opening part of s 97(1) refer to distributable income, that is to say income ascertained by the trustee according to appropriate accounting principles and the trust instrument. That the words have this meaning is confirmed by the use elsewhere in Div 6 of the contrasting expression 'net income of the trust estate'. The beneficiary's 'share' is his share of the distributable income."*
>
> *Sundberg J then continued:*
>
> > *"Having identified the share of the distributable income to which the beneficiary is presently entitled, s97(1) requires one to ascertain 'that share of the net income of the trust estate'. That share is included in the beneficiary's assessable income. The expression 'net income of the trust estate' in par (a)(i) has the meaning given it by s 95(1) – taxable income as opposed to distributable income. The words 'that share' in par (a)(i) refer*

back to the word 'share' in the expression 'a share of the income of the trust estate', and indicate that the same share is to be applied to an income amount calculated according to a different formula (taxable income as opposed to distributable income). Since the income amount may differ according to which formula is applied, the natural meaning to give to 'share' where it appears for the second time is 'proportion' rather than 'part' or 'portion'. When Parliament wanted to convey the latter meaning, as it did in ss 99 and 99A, it used the word 'part'.

The contrast between the expressions 'share of the income of the trust estate' and 'that share of the net income of the trust estate' shows that the draftsman has sought to relate the concept of present entitlement to distributable income, and not to taxable income, which is, after all, an artificial tax amount. Once the share of the distributable income to which the beneficiary is presently entitled is worked out, the notion of present entitlement has served its purpose, and the beneficiary is to be taxed on that share (or proportion) of the taxable income of the trust estate."

4.17 For the 2000 income year, the "net income" of the Trust included the amount of $191,701 which should not have been claimed as a deduction in the tax return of the Trust. As a result, the High Court held that the assessable income of Mr and Mrs Bamford should include a share of that amount, equivalent to the share they each received of the distributable income.

Whether the trust deed could re-characterise amounts

4.18 The trust deed of the Trust gave the trustee the discretion to determine whether a particular receipt should be treated as income or capital.

4.19 The trustee relied on this power to pass a resolution to distribute the first $60,000 of net income, "*… including …* [the] *…. capital gain …*" to Mr and Mrs Bamford in equal shares.

4.20 The Commissioner argued that the capital gain was not income of the Trust. Further, since there was no income, no beneficiary could be 'presently entitled' to the amount in question, the trustee of the Trust should be assessed at the special rates.

4.21 The High Court held that the term "income" as contained in s 99A of the 1936 Act should be interpreted as income of the trust estate, as understood in trust law.

4.22 As a result, the net capital gain of the Trust became the income of the Trust after the trustee exercised its discretion to characterise the capital gain as income of the Trust.

Outcome for Trust Distributions

4.23 There is no room for doubt that Bamford establishes that:

4.23.1 income of the trust estate identified in s 97(1) of 1936 Act is to be determined according to any directions set out in the Trust Deed;

4.23.2 the share of the net income attributable to a beneficiary is to be determined in the same proportions in which the beneficiary enjoys the present entitlement to the share of the income of the trust.

4.24 In this first regard, the Court made it clear that the general rules regarding apportionment between capital and income of receipts and outgoings was largely based on assumptions which could be displaced by the terms of the trust instrument: Bamford at [17]. The general law of trusts operates to give meaning to the term "the income of the trust estate".

4.25 The determination of present entitlement to a share of the income is a process of trust administration. The decision of the Full Court of the Federal Court in *C of T v Totledge Pty Ltd* (1982) 40 ALR 385 at 393 is quoted in support: Bamford at [39]. The High Court distinguished its own decision in *C of T v Australia and New Zealand Savings Bank Ltd* (1998) HCA 53 (Bamford at [39]) as not relevantly addressing the issue. Finally, the Court observed that the Commissioner's lack of consistency in wishing to exclude "statutory income" from "income of the trust estate" did not assist his argument that "income" means "income according to ordinary concepts": Bamford at [41].

4.26 On the meaning of the term "share of the net income" the High Court adopted the proportionate approach advocated by Sunberg J in *Zeta Force* (discussed above).

4.27 What does this translate into for trustees making decisions in respect of trust distributions for the 2010 income year?

4.28 There are a number of relevant observations to be made.

4.29 First, if the Trust Deed provides a formula for determining the income of the trust then that formula will determine the entitlement of the beneficiaries to income. If, for example, the Deed contains words to the following effect:

> *"The net income of the trust is an amount equal to the amount determined in accordance with subsection 95(1) of the* Income Tax Assessment Act 1936 *but reduced by any amount which would otherwise be included by application of Division 207 of the* Income Tax Assessment Act 1997*".*

4.30 Throughout this paper "subsection 95(1) terms" means an amount adjusted for the franking credit gross up. The issue of grossing up is considered below in the context of using the full tax exemption including the franking rebate available to children.

4.31 Leaving aside the elimination of any gross up for franking credits (which itself is affected by the Streaming Amendments as discussed below) the amount of net income for trust law purposes

will equal the tax law income. The two will coincide so that there should, in the ordinary course, be no amount assessable to the trustee under s 99A of the 1936 Act.

4.32 Secondly, if the Trust Deed is silent then "ordinary income" principles apply. Just what they are is difficult to say. The ATO has expressed the view that income of a trust is income according to ordinary principles. This is not the same thing as accounting income determined in accordance with accounting principles. It requires a dissection of receipts into:

4.32.1 income according to ordinary principles;

4.32.2 income which is not ordinary income;

4.32.3 capital receipts.

4.33 Following that dissection, the expenses must be apportioned accordingly.

4.34 This is, of course, all too much. Many trust deeds will have a clause like that in Bamford which allows the trustee to determine whether a receipt is capital or income. Others will have very broad powers allowing the trustee to determine the basis on which income of the trust is to be worked out.

4.35 If these powers exist they should be used to avoid uncertainty brought about by the "ordinary income" approach. If they do not exist then the deed should be to give the trustee such a power. Whether such an amendment will amount to a resettlement, which might have adverse capital gains tax (and stamp duty) consequences, is discussed at **paragraphs xx** below.

4.36 Thirdly, because the proportionate approach has prevailed, a strict application of that rule will mean that great care needs to be taken when seeking to direct a specific amount of tax law net income to a particular beneficiary with absolute certainty e.g. the maximum amount to a child which escapes the punitive rates under Division 6AA of the 1936 Act. This issue is illustrated in the Examples which follow.

4.37 Fourthly, the High Court decision says nothing about streaming of trust income. The matter was not in issue. The uncertainty about streaming of income according to its character remained unabated, until the Streaming Amendments.

4.38 Finally, the ATO has done away with the benevolent "capital beneficiary" approach set out in Practice Statement PSLA 2005/1 (GA) on and from 13 October 2010.

Examples

4.39 The best way to illustrate these points is by way of example. In the examples which follow the following facts apply in relation to the A Family Trust for the income year ended 30 June 2010:

Receipts:

rent	$50,000
net capital gain	$100,000

Expenses:

rental expenses	$10,000
interest	$20,000

4.40 The interest relates to the rental property only. The discountable capital gain was made on the sale of shares in a listed company. The intended beneficiaries are Mr and Mrs A and their two children both under 18.

4.41 Because of the low income rebate the following no-tax thresholds apply to minors:

Income Year end 30 June	**$**
2010	3,000
2011	3,333

4.42 If the income constitutes fully franked dividends the cash payment thresholds and grossed up taxable income amounts are:

Income Year end 30 June	**$ cash**	**$ taxable income**
2010	6,300	9,000
2011	7,000	10,000

4.43 These figures have considerable significance for trustees seeking to hit the no tax "sweet spot" for a distribution to a child.

(a) Subsection 95(1) terms apply – no "balance approach"

4.44 The taxable capital gain is $50,000. Accordingly, the distributable trust income is $70,000.

4.45 For 2010 a minor may be distributed $3,000 with no tax liability if entitled to the low income rebate (see comments above).

4.46 The trust distribution minutes might give effect to the following:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000

70,000

4.47 The tax law results will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.48 The cash in the trust will include the $50,000 covered by the 50% general CGT discount. This is not income and can be dealt with as capital. As this is a discretionary trust it can be distributed without tax consequences.

(b) Ordinary income applies – no "balance approach"

4.49 In this instance the trust distribution minutes will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	7,000
Mr A	7,000
	20,000

4.50 The tax law results will be:

	$
Child 1	$3{,}000 + {}^{3,000}/_{20,000} \times \$50{,}000$
Child 2	$3{,}000 + {}^{3,000}/_{20,000} \times \$50{,}000$
Mrs A	$7{,}000 + {}^{7,000}/_{20,000} \times \$50{,}000$
Mr A	$7{,}000 + {}^{7,000}/_{20,000} \times \$50{,}000$

4.51 The final results:

	$
Child 1	10,500
Child 2	10,500
Mrs A	24,500

Mr A	24,500
	70,000

4.52 This is a strict application of the proportionate approach.

4.53 Each of the children will pay tax on $7,500 at the Division 6AA punitive rates of 45%. This is not a good result.

(c) Subsection 95(1) applies – "balance approach" used

4.54 Trust minutes:

	$
Child 1	3,000
Child 2	3,000
Mrs A	half of the balance
Mr A	half of the balance

4.55 Trust income entitlements:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.56 The tax law result:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.57 This is the same outcome as where no "balance approach" is applied – but see below for the effect of a tax adjustment.

(d) Ordinary income applies – "balance approach" used

4.58 Trust minutes

	$
Child 1	3,000
Child 2	3,000
Mrs A	half of the balance
Mr A	half of the balance

4.59 Trust income created will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	7,000
Mr A	7,000
	20,000

4.60 The tax law results will be:

	$
Child 1	$3{,}000 + {}^{3,000}/_{20,000} \times \$50{,}000$
Child 2	$3{,}000 + {}^{3,000}/_{20,000} \times \$50{,}000$
Mrs A	$7{,}000 + {}^{7,000}/_{20,000} \times \$50{,}000$
Mr A	$7{,}000 + {}^{7,000}/_{20,000} \times \$50{,}000$

4.61 The final results:

	$
Child 1	10,500
Child 2	10,500
Mrs A	24,500
Mr A	24,500
	70,000

4.62 Again there is no difference. However, the "balance approach" is more realistic because it is unlikely that the trust income or tax law income will be known as at any 30 June. In reality these figures are not known until the accounts are drawn later in the calendar year.

(e) Tax Law Adjustments

4.63 It is often important to anticipate an adjustment to the trust's tax law income especially where there is something contentions going on.

4.64 As has been seen the tax law result will follow on a proportionate basis the entitlements to income created under the Deed. To test the outcome it is assumed in the above examples that the trustee failed to recognise $10,000 of rental income (say the trustee at first considered that the income was to be deferred until the 2011 income year) but was in fact wrong about this.

4.65 How do the various approaches deal with such an adjustment?

Example (a) – subsection 95(1) applies (but no "balance approach")

4.66 The trust law entitlements and tax law results were the same:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.67 The tax law adjustment will increase both the trust law entitlement and the tax law income by $10,000. The Trustee has not dealt with this $10,000 and, without an operative default beneficiary clause, it will be assessed to the Trustee under section 99A of the 1936 Act.

4.68 The trust law entitlements and tax law result will be:

	$
Child 1	3000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
Trustee	10,000
	80,000

4.69 However, if there is no streaming of the capital gain (with the effect that all beneficiaries are entitled to a proportionate part of the capital gain) that part of the capital gain reflected in the income to which no beneficiary is presently entitled will be grossed up for the loss of the 50% general CGT discount. Five eighths of the $10,000 adjustment assessed to the Trustee is capital gain. As a result the share of the net income assessable to the Trustee will be increased by $6,250.

4.70 The final result will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
Trustee	16,250
	86,250

4.71 This is a costly outcome.

Example (c) – subsection 95(1) but using a "balance approach".

4.72 The trust law entitlement and tax law result were the same.

	$
Child 1	3,000
Child 2	3,000
Mrs A	half of the balance
Mr A	half of the balance

4.73 The unadjusted result was:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.74 The adjusted trust law entitlement and tax law result will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000 + 5,000
Mr A	32,000 +5,000
	80,000

4.75 The "balance approach" together with adoption of s 95(1) terms directs all of the tax law result from an adjustment made by the ATO to the balance beneficiaries.

4.76 If the balance distribution has been used Mr and Mrs A will "enjoy" a further $5,000 of income entitlement (it now having been correctly determined) and a further $5,000 of tax law net income each. No amount will be assessed to the trustee.

4.77 There is an argument that the beneficiaries have not become presently entitled to the amount of the adjustment to the trust law net income as it was not ascertained at the end of the income year. In the writer's opinion the trust law net income was always the amount as correctly adjusted by the ATO. There was never any uncertainty about it. It is simply the case that the trustee and ATO had not properly determined the correct quantum of income.

4.78 In practical terms how have the Courts looked at the "balance approach"? It has not come up that often.

4.79 The decision of Cooper J in *BRK (Bris) Pty Ltd v C of T* [2001] FCA 164 might at first blush give cause for concern. There the Court considered the operation of the default beneficiary clause in the Trust Deed. The distributions had been:

1993 income year:

"Hendon Unit Trust 100%

and Resolved that should the Commissioner of Taxation disallow any amount as a deduction or include any amount in the assessable income of the Trust, such amount or amounts are to be deemed distributed on 30th June 1993 in the same proportions as listed above to the beneficiaries listed above".

1994 income year:

(a) The sum of $304,021.72 to Westside Commercial Centre Pty Ltd as trustee of the Hendon Unit Trust for its absolute benefit.

(b) The following sums to the following beneficiaries for their absolute respective benefits: NIL

(c) The Balance to Jessica Wagner and Bill Wagner equally between them for their absolute benefit.

1995 income year:

Hendon Unit Trust	*First $220,000*
Northbourne Trust	*Next $100,000*

Wilhelm J Wagner and Jessica O Wagner	*Remainder of balance equally*

4.80 The same "variation of income" clause as in 1993 applied in this year.

4.81 It would appear that the Trust Deed did not adopt subsection 95(1) terms and that income was ordinary income.

4.82 It was found that the Hendon Unit Trust was not an object of the Trust and the distribution of income to it failed. The default beneficiaries clause distributed income in default of appointment to the beneficiaries described in the Schedule to the Deed as tenants in common. This was the usual wide class of family objects.

4.83 The Court concluded that the default beneficiary clause did not operate as at 30 June because the trustee had a reasonable time after the end of the income year in which to decide to distributed or accumulate.

4.84 The question arose as to whether the balance clause in the 1994 and 1995 determinations operated to take the amounts which the Trustee had attempted to distribute to the Hendon Unit Trust to Mr and Mrs Wagner. It was concluded that this was not the effect of the distribution minute and, as a result, the Trustee was assessable under section 99A.

4.85 At [40] Cooper J concluded:

> *"In my judgment the submission is misconceived. In the 1994 income year the clear intention of the applicant was to appoint to Mr and Mrs Wagner only so much of the Trust income, if any, as exceeded $304,021.72 in addition to any income in excess of that amount in the event that the appointment to WCC should fail. The position is no different in respect of the 1995 year. The trustee purported to appoint discrete amounts of income to the Hendon Unit Trust as to the first $220,000 and to the Northbourne Trust as the next $100,000. Finally, as to any remainder after the application of the first $320,000 of income, that remainder was to be appointed to Mr and Mrs Wagner; they did not as a matter of construction or intention on the part of the trustee, take by default all of the income in the event of failure of the other two appointments."*

4.86 Rather than being a cause for concern about the "balance approach" the decision of Cooper J on this point supports its operation. The specific quantum entitlements fix the income (and tax where s 95(1) terms apply) at the amount specified in the Trustee's determination. If the gift fails it does not flow to the balance beneficiary but to the default beneficiary or, in the alternative, there is no such entitlement created, giving rise to a s 99A assessment to the trustee.

4.87 Further comfort can be obtained from observations made in *C of T v Ramsden* [2005] FCAFC 39. In that case the Court was concerned with the issue whether a beneficiary had effectively renounced a distribution of income.

4.88 The distribution minutes for the 1996 income year provided:

"Steve Hart Family Holdings No.2	*$17,295*
Steve Hart Family Holdings No.3	*$6,639*
Unlimited Aerobatic Discretionary Trust	*$34,810*
The Adcock Practice Trust	*$429,000*
Troy B Hart	*$4,750*
Steven I Hart	*The Balance"*

4.89 It was agreed that the Adcock Practice Trust did not qualify as a beneficiary. The default beneficiary clause provided for income which had not been appointed prior to year end to be held for Steven Hart and his three children as tenants in common. The ATO assessed each of the default beneficiaries to one quarter of the amount which had failed to be appointed to the Adcock Practice Trust.

4.90 The argument was pressed before the primary judge that the income should pass by way of the balance distribution to Steven Hart: Ramsden at [38] to [41]. Justice Spender's rejection of this argument was confirmed by the Full Court. It was observed at [2005] FCAFC 39 at [72]:

> *"We agree with this construction. 'The Balance' does not include the amounts which precede "The Balance" in the resolution of 30 June 1996.*
>
> *'The Balance' is the Income of the Trust for the year ended 30 June 1996 other than the amounts which precede it in the resolution in question, whether effectively appointed or not".*[2]

4.91 This observation supports the "balance approach" taken in this paper where there have been effective distributions. Note, however, that it will not work where a distribution is ineffective. In such a case the adjustment will be assessed to the default beneficiary, if there is one, or to the trustee.

Example (d) – Ordinary Income with balance approach applying

4.92 The trust law entitlements were:

	$
Child 1	3,000

[2] [2005] FCAFC 39 at para. 72.

Child 2	3,000
Mrs A	half of the balance
Mr A	half of the balance

4.93 Trust income entitlements:

	$
Child 1	3,000
Child 2	3,000
Mrs A	7,000
Mr A	7,000
	20,000

4.94 The tax law result was:

	$
Child 1	10,500
Child 2	10,500
Mrs A	24,500
Mr A	24,500
	70,000

4.95 When the tax law income is adjusted by $10,000 there is no change to the trust law result. The tax law result will be:

	$
Child 1	$10,500 + {}^{10,500}/_{70,000} \times \$10,000$
Child 2	$10,500 + {}^{10,500}/_{70,000} \times \$10,000$
Mrs A	$24,500 + {}^{24,500}/_{70,000} \times \$10,000$
Mr A	$24,500 + {}^{24,500}/_{70,000} \times \$10,000$

4.96 The final result will be:

	$
Child 1	12,000
Child 2	12,000
Mrs A	28,000
Mr A	28,000

	80,000

4.97 The result has only become worse from a Division 6AA income perspective.

Will a "default beneficiary" clause in the Deed assist?

4.98 An income default beneficiary clause would be expressed something like:

> *"If the Trustee has not determined to distribute all of the net income of the Trust by the end of the Income Year the Income Default Beneficiary will be absolutely entitled to that part of the net income which has not been distributed."*

4.99 The term "Income Default Beneficiary" will be appropriately defined to identify individuals or companies.

4.100 In Example (a) – subsection 95(1) terms but no "balance approach" – a default beneficiary clause would have deflected the tax adjustment from the trustee to the default beneficiary.

4.101 In Example (b) – ordinary income but no "balance approach" – the default beneficiary clause would have no effective operation as all of the trust law/tax law income has been accounted for.

4.102 The trust entitlements were:

	$
Child 1	3,000
Child 2	3,000
Mrs A	7,000
Mr A	7,000
	20,000

4.103 The tax law result was:

	$
Child 1	10,500
Child 2	10,500
Mrs A	24,500
Mr A	24,500
	70,000

4.104 If the tax law income is increased by $10,000 the trust law income does not alter. The tax law adjustment is apportioned according to the trust law income apportionments, as follows:

	$
Child 1	10,500 + $^{3,000}/_{20,000}$ x 10,000
Child 2	10,500 + $^{3,000}/_{20,000}$ x 10,000
Mrs A	24,500 + $^{7,000}/_{20,000}$ x 10,000
Mr A	24,500 + $^{7,000}/_{20,000}$ x 10,000[3]
	70,000

4.105 The final tax results will be:

	$
Child 1	12,000
Child 2	12,000
Mrs A	28,000
Mr A	28,000
	80,000

4.106 In Example (c) – subsection 95(1) terms and a "balance approach" – the default beneficiary clause has no role to play because the adjustment will always be directed to the balance beneficiary.

4.107 In Example (d) – ordinary income and "balance approach" – the default beneficiary clause has no need to operate because the tax adjustment will simply be apportioned in accordance with the trust law entitlements which don't change.

Summary re Tax Adjustments

Trust Accounting Basis	Tax Law Income	Trust Income	Adjustment to (if no default beneficiary)	Adjustment to (if there is a default beneficiary)
subsection 95(1) – no "balance approach"	+ $100	+ $100	Trustee	Default Beneficiary
subsection 95(1) – "balance approach"	+ $100	+ $100	Balance Beneficiaries	Balance Beneficiaries
ordinary income – no "balance approach"	+ $100	no change	All Beneficiaries	All Beneficiaries
ordinary income – "balance approach"	+ $100	no change	All Beneficiaries	All Beneficiaries

[3] The proportions remain the same whether the trust law or tax law results are used.

Guidance from Bamford

4.108 As the High Court observed in Bamford at [17]:

> *"… both sides in argument on the present appeals accepted that whichever of the competing constructions of Div 6 were accepted examples could readily be given of apparent unfairness in the resulting administration of the legislation"*

4.109 In reaching the conclusion that the terms of the Trust Deed determine the trust income to which a beneficiary may be made entitled the High Court has gone very far towards resolving most of the problems and uncertainties which confronted practitioners and the trustees and beneficiaries they advise. With a good understanding of the terms of the Trust Deed as they effect trust distributions most distribution problems can be addressed.

4.110 As has been demonstrated in the above worked examples adopting a s 95(1) terms plus "balance approach" achieves the following:

4.110.1 the quantum of tax distribution to children can be locked in.

4.110.2 any "normal" tax adjustment will flow to the balance beneficiaries.

4.110.3 if used in conjunction with a default beneficiary clause ineffective distributions can also be dealt with.

4.111 The subsection 95(1) but without a "balance approach" can lead to:

4.111.1 an assessment of the tax adjustments to the trustee under section 99A;

4.111.2 clawback of any general CGT discount.

4.112 This can be addressed by using a default beneficiary (of course the default beneficiary should not be a company where the general CGT discount is involved).

4.113 The balance approach together with a considered default beneficiary is to be preferred as the outcome is more predictable.

4.114 The ordinary income approach is problematic because it is:

4.114.1 too difficult to calculate what is net ordinary income;

4.114.2 and tax law adjustments will be spread across all beneficiaries (as there is no adjustment to the net income).

5. Div 7A Amendments

5.1 Division 7A of Part III of the 1936 Act deals with accessing wealth in private companies without accounting for the tax that would otherwise be payable on the value accessed. It focuses on three means of accessing wealth in private companies – payments from a private company, loans from a private company or the forgiveness of a debt by a private company to an associate of that company.

5.2 In 2010 there were two broad changes to the Division 7A interacts with trusts:

5.2.1 The Div 7A Amendments; and

5.2.2 The Commissioner's position in *Taxation Ruling 2010/3* and *Practice Statement Law Administration* 2010/4.

5.3 The changes to Division 7A include the insertion of an introductory note to Division 7A stating:

> An amount may also be included in the assessable income of a shareholder or shareholder's associate if:
>
> (a) a company has an unpaid present entitlement to income of a trust; and
>
> (b) the trustee makes a payment or loan to, or forgives a debt of, the shareholder or associate.
>
> (See Subdivisions EA and EB.)

5.4 This note is of interest as it strongly suggests that Subdivision EA is a 'code' which is intended to capture arrangements where there is an unpaid present entitlement subsisting between a trust and a corporate beneficiary and there is then a loan, payment or forgiveness that occurs between the trustee and a shareholder or an associate of a shareholder in the corporate beneficiary.

5.5 This should be contrasted with the position in the ATO *Taxation Ruling* 2010/3 where the ATO assert that subdivision EA has much more limited effect, where they generally restrict its operation to the situation where there is a sub-trust in existence between a trustee and a corporate beneficiary and there is then loan, payment or forgiveness involving a shareholder or an associate of a shareholder and the trustee of the sub-trust.

5.6 In the 31 March 2010 NTLG meeting the professional bodies questioned the ATO as to whether the introduction of this provision into Division 7A cast doubt on the position in their draft ruling. The meeting agenda includes the following discussion:

> The ATO does not see a conflict between the legislation of provisions dealing with unpaid present entitlements and the position set out in Draft Ruling TR 2009/D8.

This is because, contrary to the premise of the question, under Draft Ruling TR 2009/D8 unpaid present entitlements will retain that status for Division 7A purposes in many situations, including where:

- the amount representing the UPE is physically held on sub-trust for the sole benefit of the private company beneficiary;
- the amount representing the UPE is being used by the trustee but all benefits from this use are held for the sole benefit of the private company; or
- the private company beneficiary is not aware and cannot be taken to be aware that the funds representing its UPE are being used for the potential benefit of any or all discretionary objects of the trust (rather than being physically set aside or used for its sole benefit).

The ATO has appropriately consulted with Treasury prior to and during the drafting of TR 2009/D8.

Provisions within Division 7A dealing with unpaid present entitlements will continue to have their intended application and there is no inconsistency between the Exposure Draft legislation and the draft Ruling.

Use of assets

5.7 As was announced in the 2009/10 Federal Budget the use of assets owned by private companies, or owned by trusts where there is a present entitlement owing to a private company may be subject to tax after 1 July 2009.

5.8 The way in which the use of assets will become subject to tax is through the amendment of the definition of the term 'payment' in Division 7A so that it extends to the provision of an asset (other than a transfer of property) for use by an entity. Consistent with the present operation of Division 7A the provision of the asset will only result in Division 7A consequences where the asset is provided to a shareholder or associate of a shareholder.

5.9 For the purposes of Division 7A the payment will occur when the use of the asset occurs.

5.10 A payment will also arise however where the asset is not used, but is available for use. The examples in the EM are illustrative of when it will be the right to use the asset, and not its use, that is subject to the Division 7A rules.

> ***Example (right to use from EM)***
> ***Brian is a shareholder of a private company that owns a luxury yacht. He does not have a formal agreement with the company in relation to the yacht, however, he takes the yacht out every second weekend.***
>
> ***Brian keeps the yacht at the company's business premises, but takes the key home. Brian stores several personal items on the yacht.***
>
> ***Brian's fortnightly use of the yacht is a payment under Division 7A. The availability of the yacht for Brian's use is also subject to Division 7A because the yacht is not readily available for use by the company. The company would need to arrange with Brian to***

get the key and for the removal of Brian's personal items before using the yacht. That is, the asset is available for Brian's use to the exclusion of the company.

Example (use from EM)
Marina is a shareholder of a private company that owns a city apartment. The apartment is generally available for rent. However, Marina asks the company not to rent the apartment out for a week so that she and her family can use the apartment over a long weekend. Marina's use of the apartment is a payment for the purposes of section 109CA.

5.11 An issue that arose on consultation over the draft legislation giving effect to these changes was whether the mere availability of assets to a shareholder or associate would result in the shareholder or associate being treated as having the asset available for their use. The EM again includes an example where there a payment is not taken to arise where an asset is available as a result of a general entitlement to use an asset without actual use of the asset.

Example (mere entitlement from EM)
Peter is a shareholder of a private company that owns five cars for company use. Shareholders and their associates have general permission to use the cars on weekends if they are not being used for company business. Peter regularly takes one of the cars home.

Peter's use of the car that he takes home will be subject to Division 7A. This will include driving the car (actual use) and the availability of the car for his use to the exclusion of the company, such as when it is parked at home, or at a restaurant that Peter is visiting.

Although Peter may have general permission to use all five of the cars, he does not use all of them for the purposes of Division 7A. The four cars that Peter leaves at the company premises are available for the company to loan to another shareholder, employee, customer, or other party. That is, these cars are not available to Peter to the exclusion of the company.

5.12 The EM also includes examples of where an asset is available to more than one shareholder or associate and it is necessary to determine who is taxed. The EM suggests and apportionment of the taxable value to the person who is the real recipient of the benefit. One example sets out that a minor that benefits should not be taken to receive a Division 7A payment, where another sets out that incidental use by a spouse of a vehicle provided to a shareholder would not result in the spouse being taxed on the benefit provided.

5.13 In valuing the payment taken to be made it will be the amount that would have been paid for the use of the asset in an arm's length dealing less any consideration paid that will be determined to be the payment for Division 7A purposes.

5.14 There are a number of exceptions from the payment provisions applying, including one not previously announced dealing with residential property:

5.14.1 Minor benefits – if the provision of the asset would have been a minor benefit under section 58P of the FBTAA had it been provided to an employee then the benefit will be disregarded for Division 7A purposes

5.14.2 Otherwise deductible payments – if a once off deduction would have been available to the shareholder or their associate in connection with the use of the asset then there will be no benefit to be taken into account for Division 7A purposes.

5.14.3 Dwellings – the use of a dwelling can be exempt where the following conditions are satisfied:

5.14.3.1 the entity or their associate is carrying on a business;

5.14.3.2 the entity or their associate uses or is granted or has a lease, licence or other right to use land, water or a building for the purpose of carrying on the business; and

5.14.3.3 the provision of the dwelling to the entity is connected with that use or with that lease, licence or other right to use the land, water or building to carry on the business.

5.14.4 Main residences – the provision of a dwelling that is a person's main residence does not result in a Division 7A payment where:

5.14.4.1 The provider of the dwelling is a private company;

5.14.4.2 The private company acquired the dwelling before 1 July 2009; and

5.14.4.3 The private company would pass COT from the time that the dwelling was acquired until the end of the time that a payment could be taken to be made under Division 7A.

5.14.5 Vacant land – if the exception for a dwelling or a main residence applies, it will extend to adjacent land in the same way as occurs in the main residence exemption.

Corporate limited partnerships

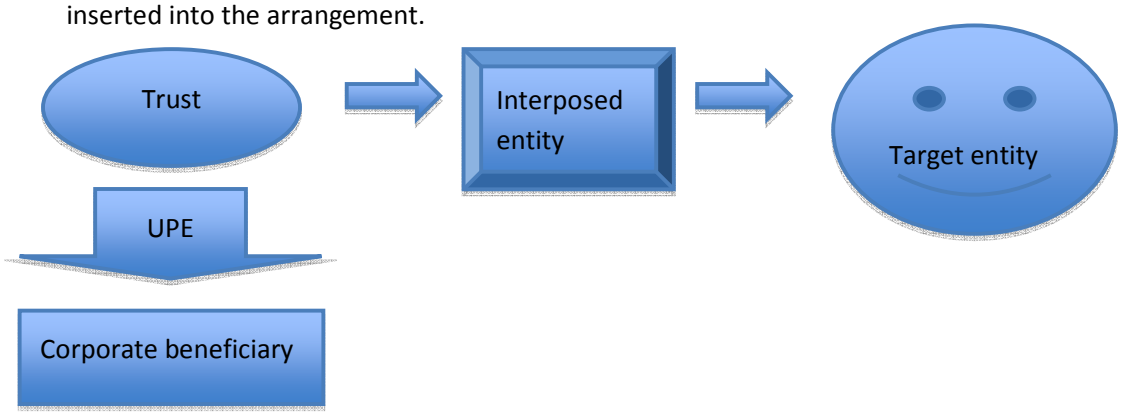
5.15 Closely held corporate limited partnerships (limited liability partnerships) will also now be subject to Division 7A. A corporate limited partnership will be closely held where it has fewer than 50 members or where an entity has, directly or indirectly, for the entity's own benefit, an entitlement to 75% or more of the income and capital of the partnership.

Interposed entities

5.16 The Div 7A Amendments fix two drafting issues in relation to the use of interposed entities.

5.17 The Division 7A legislation as originally drafted allowed for a payment by a private company through an interposed entity to be treated as a payment for Division 7A purposes.

5.18 The legislation did not however on a plain reading, allow for a trust where there was an unpaid present entitlement, to be deemed to have made a payment where an interposed entity was inserted into the arrangement.



5.19 A payment from the trust through an interposed entity to a target entity will now be caught by Division 7A if a reasonable person would consider that a loan or payment made to the interposed entity was made to enable a loan or payment to be made by the interposed entity to the target entity.

5.20 Consistent with the current operation of Subdivision EA however, a payment through to the target entity will only result in a Division 7A deemed dividend if it is referable to a reduction in a present entitlement that is in itself attributable to an unrealised gain in the trust.

5.21 The Div 7A Amendments also ensures that where an unpaid present entitlement is owed to a company by a trust, but the loan, payment or forgiveness that occurs does not involve the trust that owes the unpaid present entitlement, that Subdivision EA still has effect.

5.22 Subdivision EA will apply to treat a loan or payment from a trust as being a Division 7A loan or payment to the extent that the loan or payment is referable to an unpaid present entitlement owed to a private company where that amount has not already resulted in a Division 7A loan or payment.

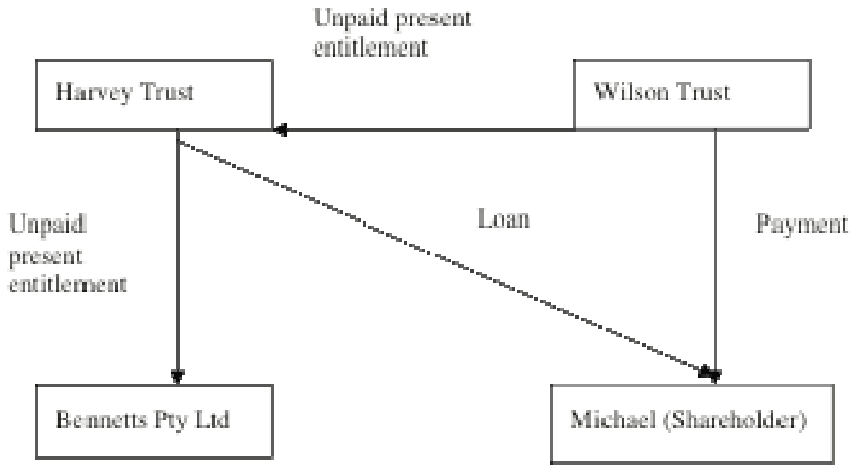
Example (interposed trust from EM)
Michael is a shareholder of Bennetts Pty Ltd and Bennetts Pty Ltd is a beneficiary of Harvey Trust. In the 2009-10 income year, Michael receives a payment from the trustee of the Wilson Trust, which is attributable to an unrealised gain. He receives this payment

because of his shareholding in Bennetts Pty Ltd. Michael also receives a $2,000 non-compliant Division 7A loan from the Harvey Trust.

Bennetts Pty Ltd is not presently entitled to an amount from the net income of the Wilson Trust. However, Bennetts Pty Ltd is entitled to $10,000 from the net income of the Harvey Trust (the first interposed trust) and Harvey Trust is presently entitled to $10,000 from the net income of the Wilson Trust. These amounts remain unpaid.

The loan made by the Harvey Trust to Michael will be included in Michael's assessable income under ordinary operation of subsection 109XA(2).

Bennetts Pty Ltd is taken to be presently entitled to $8,000 from the Wilson Trust, which is the unpaid present entitlement of $10,000 from the Harvey Trust, reduced by the $2,000 loan amount that is included in Michael's assessable income under another provision of Subdivision EA.



Loan back arrangements

5.23 Subdivision EA as currently drafted only captures payment arrangements where the payment is a reduction of a present entitlement that is referrable to an unrealised gain.

5.24 To circumvent these rules, apparently it had been suggested that the following arrangement could be entered into:

5.24.1 An unpaid present entitlement exists to a private company, say of $100,000.

5.24.2 A payment is made by the trustee of the trust to a beneficiary of an amount far in excess of the UPE, for example $1 million.

5.24.3 The amount in excess of the UPE is then loaned back to the trustee, being $900,000.

5.24.4 Thus, the beneficiary now has a credit loan of $900,000.

5.24.5 In future years the trustee appoints income to the company and uses the funds to repay the credit loan.

5.25 The need for there to be a payment referrable to a reduction of an unrealised gain will be removed where the payment made to a beneficiary is in reduction of a loan made on or after 1 July 2009 where a reasonable person would conclude that the trustee obtained the loan in order to make the payment.

Amendment to distributable surplus definition

5.26 The definition of distributable surplus will be amended so that amounts that have been deemed to be dividends as a result of the operation of Subdivision EA will be removed from the distributable surplus (by being correctly included as non-commercial loans).

Forgiveness of 109XB loans

5.27 There is a drafting problem that will be rectified so that the forgiveness of a loan by a trustee that has already been deemed to be a dividend will not result in a subsequent dividend. The law already applies in this way to the forgiveness of a debt owed to a private company by a shareholder that has already been deemed to receive a dividend under Division 7A.

Dividend set-off

5.28 Another drafting problem dealing with dividend set-offs will also be rectified.

5.29 At present, where a private company makes a loan that is deemed to be a dividend and later pays an unfranked dividend that is set off against that loan the later dividend is not included in assessable income.

5.30 The ability to disregard the later dividend does not apply where the loan was made by the trustee of a trust and where the deemed dividend arose under section 109XB.

5.31 The ability to disregard a later unfranked dividend offset against a loan from a trustee is being introduced.

Setting off employment entitlements

5.32 Another unusual aspect of the interaction of Division 7A generally and Subdivision EA has been that employment related payments that are offset against loans by trustees do not count as repayments if there is a borrowing of a similar or greater amount to the amount repaid. This is in contrast to setting off such a payment against a loan by a company where the repayment is taken into account even if there is a further borrowing.

5.33 This anomaly is to be rectified.

Borrowing to repay

5.34 Under the previous law a repayment is disregarded where the repayment is made where a reasonable person would conclude the repayment was made in order to borrow a similar or greater amount. This prevents a person from borrowing funds during a financial year, repaying on 30 June, and then reborrowing the amount on 1 July.

5.35 While the law has operated in this way (with some exceptions for repayments that occur by way of offsetting assessable amounts such as the wages noted above) it arguably has not operated where, instead of repaying to borrow, a person borrows to repay. This was be remedied so that a borrowing to repay will also activate section 109R.

> ***Example (from EM)***
> ***Alicia obtains a loan of $10,000 from Cleary Pty Ltd. Alicia has until the lodgment day to repay the loan. Two weeks before the lodgment day Alicia obtains a further $10,000 from Cleary Pty Ltd. She then repays the original $10,000 loan a week before the lodgment day.***
>
> ***The repayment of the original $10,000 loan is not a repayment for the purposes of section 109D, because Alicia has borrowed a similar amount from Cleary Pty Ltd and in this case a reasonable person would conclude that the loan was obtained in order to make the repayment of the original $10,000.***
>
> ***The original $10,000 loan is treated as a deemed dividend subject to the distributable surplus of the private company.***

Adding back payments for Division 7A purposes

6. Streaming

6.1 The paper will no consider the importance of, and ability to, stream as it stood before the Streaming Amendments. Then it will consider the Streaming Amendments.

Pre-Streaming Amendments

6.2 As can be seen from the illustrations above the ability to stream income according to its character is very important. This is particularly the case for franked dividends and capital gains but there are other forms of income with tax characteristics that may also be important e.g. income from a foreign source, income which has been subject to TFN withholding tax.

6.3 The decisions in Bamford tell us nothing about streaming income for tax purposes.

6.4 Most modern trust deeds will give the trustee power to distinguish between classes of income and to characterise a particular amount of income as having been derived from a particular source. The Deed should also allow the trustee to allocate expenses to the different classes of income.

6.5 The law regarding streaming after the decision in *CPT Custodian Pty Ltd v Commissioner of State Revenue [2005] HCA 53* ("**CPT Custodian**") was quite uncertain. The decision of the High Court in *Charles v C of T [1954] HCA 16* ("**Charles**") has always been the centre of gravity of the character flow through approach. The decision in Charles was heavily criticised by the Court in CPT Custodian. The question is whether that criticism went to the maintenance of character or is restricted to the characterisation of the interest in the trust fund by looking through to the underlying assets.

6.6 The decision of the High Court in CPT Custodian, in the writers' views, stands for the proposition that a beneficiary has an equitable interest in the residue of the trust fund after the Trustee's indemnity has been satisfied. This residue is characterless, whether it be income or capital, as the trustee may at any time satisfy its right to be indemnified from the receipts (which themselves have character).

6.7 Notwithstanding these problems the ATO has consistently taken the view that the character of the income in the hands of the beneficiary is taken from the character of the receipts of the Trustee[4] even after taking into account the decision in *CPT Custodian*[5].

6.8 In the non-binding ruling IT2328 (now withdrawn) it was observed:

> *"For income tax purposes where a beneficiary in a trust estate is presently entitled to the net income or a share of the net income of the trust estate, that income as a general principle has the same character in the hands of the beneficiary as it had in the hands of the trustee."*

6.9 The most significant streaming issues concern capital gains and dividends. In the case of capital gains Division 115 of Part 3-1 of the 1997 Act proceeds on an implication that income entitlements will take on at least some part of the character of the capital gains derived by the trustee. There is no clear legislative follow through. The guidance found in Sesction 115-200 of the 1997 Act establishes the implied maintenance of character:

> *"This Subdivision sets out rules for dealing with the net income of a trust that has a net capital gain. The rules treat parts of the net income attributable to the trust's net capital gain as capital gains made by the beneficiary entitled to those parts."*

[4] see in particular ATO ID 2008/51 dealing with Division 13.3A of the SIS Regulations.

[5] see Taxation Ruling STR 92/13, IT2328, IT2512, IT2004 (withdrawn) and ATO ID 2007/108 (which is concerned with foreign sourced income and in respect of which subsection 6B(2A) of the 1936 Act also comes into consideration).

6.10 Subsection 115-215(1) is the nub of the provisions:

> *"The purpose of this section is to ensure that appropriate amounts of the trust estate's net income attributable to the trust estate's capital gains are treated as a beneficiary's capital gains when assessing the beneficiary, so:*
>
> *(a) the beneficiary can apply capital losses against gains; and*
>
> *(b) the beneficiary can apply the appropriate discount percentage (if any) to gains."*

6.11 The process is described as attribution rather than maintenance of source character. This may be the necessary distinction to make the rules work. There is, however, no guidance about how the attribution is to be carried out.

6.12 What is clear is that if there is no trust income to which the beneficiary is presently entitled there can be no attribution. This is a major issue where there is no trading income but there are capital gains in the Trust. Use of s 95(1) terms to describe income overcomes this problem and makes the case for attribution much clearer. The capital gain (or at least 50% of it) will be included in the income. The connection for Subdivision 115-C purposes is very clear.

6.13 The ATO has had to resort to the artificiality of the "capital beneficiary approach" in PS LA 2005/1 (GA) to achieve this sensible outcome – but this practice statement was withdrawn following Bamford.

6.14 The issues with streaming can be readily appreciated in the context of capital gains and the 50% general CGT discount. The streaming issue is, of course, the denial of the 50% CGT general discount when a trust to company distribution is in play.

6.15 Maintaining the example used above in which there is a net capital gain of $100,000, and gross rental income of $50,0000 and net rental income of $20,000.

6.16 In this instance the trustee wishes to cause the capital gain to be assessed in the hands of an individual (say Mrs A) and the net rental income in the hands of a company, A Co. If it is assumed that the Trust Deed has all of the usual income characterisation and streaming provisions and the Deed adopts subsection 95(1) terms, the outcome readily appears.

6.17 The income entitlements are:

	$	
A Co	20,000	comprising net rental income
Mrs A	50,000	comprising the capital gain
	70,000	

6.18 If the ATO took the view that streaming was unobtainable the outcome would be:

	$	$ Total
A Co	5,714 + taxable capital gain $28,572	34,286
Mrs A	50,000	50,000
		84,286

6.19 The other area of concern is franking credits. At least there is a ruling on this aspect of streaming, *Taxation Ruling* 92/13 (repealed as of 22 June 2011 because of the Streaming Amendments). The provisions of Subdivision 207-B and in particular ss 207-45 to 207-57 are consistent with flow through of the franked character of a dividend.

6.20 The fact the Example set out immediately below s 207-35(3) of the 1997 Act depends on character maintenance. It is worthwhile setting this Example out in full:

> *"A franked distribution of $70 is made to the trustee of a trust in an income year. The trust also has $100 of assessable income from other sources. Under subsection (1) the trust's assessable income includes an additional amount of $30 (which is the franking credit on the distribution). The trust has a net income of $200 for that income year.*
>
> *There are 2 beneficiaries of the trust, P and Q, who are presently entitled to the trust's income. Under the trust deed, P is entitled to all of the franked distribution and Q is entitled to all other income.*
>
> *The distribution flows indirectly to P (as P is entitled to a share of that net income and has a 100% share of the distribution under section 207-55). P therefore has an amount of assessable income that is equal to its share of the distribution. Under this subsection, P's assessable income also includes the full amount of the franking credit (as P's share of the franking credit on the distribution is $30 under section 207-57). Q's share of the net income therefore does not include any of the franking credit."*

6.21 Clearly the legislation contemplates maintenance of character for the purposes of dividend imputation.

Commissioner's Concern of Division 6 Abuses

6.22 As usual the ATO is driven by the possibility that the decision in Bamford might support some abuse and revenue loss. No matter that their interpretations lead to massive headaches for practitioners.

6.23 This much is exampled by several examples set out *in Practice Statement PS LA 2009/7* which was released prior to the decision in Bamford.

6.24 Examples 1 and 5 in particular show what the ATO is on about.

6.25 Example 1 concerns the trustee of a family trust deriving $250,000 in income during the income year and applying that income to the purchase of a holiday home. The trustee, acting in accordance with a power expressed in the terms of the Trust Deed to do so, determines that the expenditure on the purchase of the house is an outgoing on income account with the effect that the trust law income available for distribution is $5,000. One of the beneficiaries has tax losses.

6.26 The trustee distributes the $5,000 trust law income to the loss beneficiary. The losses cover the tax law income which follows the trust law income to the loss beneficiary.

6.27 The ATO expresses concern about the mismatch of the actual amount to which the beneficiary becomes entitled ($5,000) and the amount of the tax law income flowing to the beneficiary ($250,000) and the tax not paid because of the losses.

6.28 It is difficult to say why this is of concern to them. The true effect of the transaction is to maintain $245,000 in the capital of the trust. The same tax effect would be obtained by distributing all of the $250,000 to the loss beneficiary. There is no tax difference in this illustration. It is unlikely there would be a tax benefit for the purposes of Part IVA. The most likely explanation for the transaction is the financial risk the loss beneficiary has been exposed to. If the beneficiary became entitled to call on the trustee to pay him or her $250,000 the creditors may be able to stake a claim to that amount. It is a neat and sensible piece of asset protection planning.

6.29 Example 5 is about a trust which has distinct income and capital beneficiaries. The trustee has a power to determine whether receipts and outgoings are on income or capital account. The Trust Deed is amended to admit a tax exempt entity as a beneficiary.

6.30 The trust derives $100,000 of income (meaning income according to ordinary concepts) during the income year. The trustee determines that $95,000 of that amount is a capital receipt. The remaining $5,000 is the trust law income according to the Trust Deed. This amount is appointed to the tax exempt beneficiary. All of the tax law income will be assessed to the charity. It would follow that the trustee makes a capital distribution of the $95,000 to a family beneficiary.

6.31 The ATO observe in the Practice Statement that Part IVA might apply in the circumstances. In the writer's view it almost certainly would do so in particular because of the amendment to introduce the tax exempt charity as a beneficiary and the fact that prior year distributions had been made only to family members. A much more challenging (and perhaps more realistic) illustration would arise if the tax exempt charity was already an object and the trustee had made distributions to charities in the past. The Part IVA case in such circumstances would be difficult to make out. This is an example of the acknowledged "apparent unfairness in the resulting administration of the legislation" as noted by the High Court in Bamford at [17].

6.32 The ATO apparently accept that Bamford authorizes characterization of capital receipts as income for the purposes of the Deed but are not so ready to accept that ordinary income may be recharacterised as capital (as in Example 5). They appear to be fortified in this by observations made by the Full Court of the Federal Court in *Forrest v C of T* [2010] FCAFC 6 ("**Forrest**").

6.33 The relevant question before the Court there was whether Mr Forrest was entitled to a deduction for interest he had incurred in relation to funds he had borrowed to acquire units in a unit trust. The outcome turned on whether there was a fixed income component to which the funds related. The Full Court concluded that a power to determine whether any amount received by the trustee was on revenue account or capital account (clause 12 of the Deed) was not a power to change the beneficiaries' rights. In so doing they observed at [11]-[12]:

> *'In our opinion, the power conferred by cl. 12 cannot be exercised by the trustee wrongly to classify a receipt as a capital gain, when the receipt is, in truth, income, and thus deprive the appellant of his interest in the unit component of the trust. Clause 12 is not an unlimited power to be exercised in the trustee's unconfined discretion….*
>
> *Clause 12.2(a) is a power to determine how a distribution to beneficiaries is classified. That limited power is not a power which is capable of altering the beneficiaries' rights. Clause 12 is to be read consistently with the balance of the Trust Deed and an appreciation that it contains various powers of an administrative character. The words used can be given full force honestly to classify income or distributions according to law, as the appellant contended to this Court".*

6.34 It is very difficult to know how far this goes. The issue in Forrest was about whether or not the exercise of the power changed the rights as between classes of beneficiaries. Presumably the ATO would say that the exercise of the power in a case like that in Example 5 was not an "honest" classification of the receipt as capital. Hopefully the issue will not arise very often.

Point of Interest

6.35 A case of interest is *Greenhatch v FCT* [2011] AATA 479 that ostensibly concerned superannuation contributions where the answer to the superannuation question was determined by construing streaming through a trust. The case of is interest for two reasons.

6.36 First, the AAT went out of their way to note the Commissioner's interpretation of Bamford was wrong. At [49] and [50] they said:

> *Much, if not all, of the Commissioner's case turns on his rejection of any underlying conduit theory and his interpretation of the implications of the decision in Bamford.*

The Commissioner's contention that the conduit theory has no role to play is based on foundations with which we do not agree. Accordingly, those foundations do not support the conclusion he seeks to draw.

6.37 Secondly, in relation to Subdivision 207-B of the 1997 Act, being the franking credits provisions, the AAT observed at [63]:

> *Section 207-35 of the 1997 Act has an aspect that makes the conclusion [that] amounts passing through trusts to beneficiaries thereof carry the character and identity that they had in the hands of the trustee more compelling. That section includes an example that contemplates differential distributions in determining the taxation burdens that are imposed on the beneficiaries of the trust.*

6.38 Question: was it necessary to introduce the Streaming Amendments in light of the above comments? Given we have the Streaming Amendments it is of academic interest only.

Streaming Amendments

6.39 The *Tax Laws Amendment (2011 Measures No. 5) Act* 2011 (Cth) was introduced into parliament (as a Bill) on 2 June 2011, was passed unamended and assented to on 29 June 2011. They take effect from 1 July 2010. These dates show how close a call it was as the Streaming Amendments are critical for trustee decisions that were needed to be made on 30 June 2011 – one day after their royal assent.

6.40 Subject to a statement by the Commissioner – extending the time a trustee could make decisions to 31 August 2011, which has anyway passed, but the writers question the Commissioner's ability to alter what trust law[6] requires to be done on 30 June of any year – the Streaming Amendments apply to trustees resolving to deal with trust income and capital gains.

6.41 From the 2011 income year and thereafter taxable capital gains and franked distributions are dealt with under these rules.

6.42 The Streaming Amendments operate by diverting from Division 6 of the 1936 Act the franked distributions and taxable capital gains. They are assessed directly in the hands of the beneficiaries who are presently entitled to them. They do this via Subdivision 207-B of the 1997 Act for franked distributions and via Subdivision 115-C of the 1997 Act for taxable capital gains. However, for the taxable capital gains they must still pass through the method statement in s 102-5(1) of the 1997 Act.

[6] *Trustees of the Estate Mortgage Fighting Fund Trust v FCT* [2000] FCA 981 per Hill J; *Case R105,* 84 ATC 692; *Antonopoulos v FCT* [2011] AATA 431.

6.43 The Streaming Amendments have introduced a new Division 6E into Part III of the 1936 Act to prevent double taxation. It adjusts the Division 6 income and net income of the trust to take out the amounts to which the beneficiary has been made specifically entitled.

6.44 It can be seen that the specific entitlement of the beneficiary or beneficiaries is the critical aspect of the Streaming Amendments. This is required to determine tax liability.

Specific Entitlement

6.45 The notion of a specific entitlement conceals the difficulties of applying the Streaming Amendments to all trusts, be they discretionary, fixed, unit, et cetera. The mechanism by which you become specifically entitled are set out in the relevant Subdivisions: s 115-228 for capital gains and s 207-58 for franked distributions. The provisions seem substantially similar at first look but there are some significant differences.

6.46 A beneficiary is specifically entitled under s 207-58 of the 1997 Act to an amount of a franked distribution made by the trust equal to the amount calculated under the following formula

$$\text{Franked Distribution} \times \frac{\text{Share of net financial benefit}}{\text{Net financial benefit}}$$

6.47 The "net financial benefit" is an amount equal to the financial benefit referable to the franked distribution (after an application by the trustee of expenses that are directly relevant to the franked distribution).

6.48 The term "financial benefit" is already in s 995-1 f the 1997 Act. It means anything of economic value, even if the transaction also imposes an obligation on the entity. Benefits and obligations are to be looked at separately and not set off against each other, but it is the net financial benefit to which the formula looks.

6.49 The "share of the financial benefit" is the amount of the financial benefit referable to the franked distribution specifically linked to the particular beneficiary. The share of the net financial benefit is:

> *… an amount equal to the *financial benefit that, in accordance with the terms of the trust:*
>
> *a. the beneficiary has received, or can be reasonably expected to receive, and*
>
> *b. is referable to the *franked distribution (after application by the trustee of any expenses that are directly relevant to the franked distribution) and*
>
> *c. is recorded, in its character as referable to the franked distribution, in the accounts or records of the trust no later than the end of the income year.*

6.50 Section 115-228 is identical to the discussion above of franked distributions, subject to:

6.50.1 the financial benefit must be referable to the capital gain "after application by the trustee of any losses, to the extent that the application is consistent with the application of capital losses against the capital gain in accordance with the method statement in subsection 102-5(1)"; and

6.50.2 the recording of the financial benefit must be "no later than 2 months after the end of the income year."

Complexities and Going Forward

6.51 An issue to be mindful of is – in fact an issue of significant importance – is that a trust with no "income", which was one of the problems in the Bamford appeals, will not be able to stream franking credits. This will mean that where the franked distributions, together with other ordinary income, is insufficient to more than offset expenses of the trust the franking credits cannot go through to the beneficiaries. The same restriction does not apply in relation to capital gains streamed through the trust.

6.52 Ken Schurgott FTIA, in his paper in the August 2011 *Taxation in Australia* titled "Trust streaming 2011" notes a number of complications that arise from the Streaming Amendments:

> *As will be seen, there are a number of issues which emerge that complicate the legislation over and beyond the rather simple approach adopted prior to the Commissioner's stance on streaming. The things which complicate matters are:*
>
> *a. There can be different outcomes according to the definition of income adopted by the trust deed;*
>
> *b. Significantly different outcomes can result where a beneficiary has not been made specifically entitled to the franked distribution or capital gain. This is most pronounced in relation to capital gains;*
>
> *c. The concept of making a beneficiary entitled to the entire financial benefit from a capital gain or franked distribution is fraught with difficulty, particularly where there are capital losses or directly related expenses; and*
>
> *d. The way in which capital losses and directly related expenses are to be dealt with is confusing.*

6.53 It can be seen from these further issues, and the problem of actually apply what is a simple concept of diverting the amounts to Subdivisions 115-C and 207-B respectively, are anything but straightforward or settled. Indeed, a senior council on the writer's floor, after having advised on

the Streaming Amendments is of the view that this is where future archeologists will find the bones of 21st Century tax lawyers and accountants.

7. Changes to the taxation of trusts – terms to be provided for in a trust document

7.1 Given the changes in the taxation of trusts, it is recommended that trust deed (or any other constituent documents) be reviewed so as to determine:

7.1.1 How income, capital gains and outgoings are accounted for and determined; and

7.1.2 How income, capital gains and outgoings are to be distributed.

7.2 Some of the powers which may be advantageous to have within a trust instrument include:

7.2.1 an accounting policy which is sufficiently broad and allows the trustee to exercise maximum discretion;

7.2.2 the discretion to reclassify and allocate income and capital gains;

7.2.3 the discretion to reclassify and allocate outgoings;

7.2.4 the discretion not to recoup losses (whether income or capital in nature);

7.2.5 the ability to allocate and stream classes of income and capital and their related tax attributes;

7.2.6 and ensure that any unpaid present entitlement / loan provisions are removed, and an ability to hold amounts subject to a sub-trust.

7.3 Some additional powers to be considered include:

7.3.1 whether the trustee has the power to distribute income and / or capital at any time within a tax year;

7.3.2 whether any determination of income (or capital) can be made within the income tax year; and

7.3.3 whether the trustee has a power to determine entitlements with respect to an income tax year after the relevant year.

Accounting policy

7.4 Essential is ensuring that the trust deed provides guidance with respect to an accounting policy that should be used by the trustee. Such an accounting policy should provide sufficient flexibility for the trustee, so that it may depart from generally accepted accounting standards in the event that the trustee considers that it is appropriate to do so.

Reclassifying and allocating income and capital

7.5 As the High Court in *Bamford* accepted that the tax law income of a trust is dependent upon (amongst other things) the definition of that term in the trust deed, regard should be given to the definition of the 'income' as contained in the trusts constituent documents.

7.6 An issue to consider is whether attributed amounts (e.g. franking credits) should be included within the definition of trust income. An issue that arises is that if attributions are included in trust income (and which are not physically 'paid' by a trustee – but which follow certain amounts of income), whether by being included in trust income, and thereby providing that a trustee creates a 'present entitlement' in a beneficiary to an amount that is never received by a trustee, the trustee will be exposed to a claim in relation to amounts that are not actually received by the trustee.

7.7 It is submitted that amounts such as franking credits should be prima facie carved-out of the definition of income. However, the definition should contain discretionary elements to allow a trustee to cause such 'attributed' amounts to fall within the definition of income.

7.8 An approach which may be considered is, in defining trust income:

7.8.1 Provide that it prima facie equals the amount provided for in s 95(1) of the 1936 Act (less any franking credits);

7.8.2 If the tax law approach is not warranted for a particular tax period, then:

7.8.2.1 According to an accounting policy adopted by the trustee; or

7.8.2.2 Any other basis as determined by the trustee; or

7.8.3 In the trustee's absolute discretion, the gross income of the trust.

Reclassifying and allocating outgoings

7.9 In *Cajkusic v FC of T (No 2)* (2006) ATC 4752 ("**Cajkusic**") deductions allowable to a family discretionary trust for payments that were made under an employee benefits trust arrangement in the income tax years ending 30 June 1997 and 30 June 2008 caused there to be a loss within the trust estate.

7.10 As a result of the losses, there was no distributable income of the trust. As a result, the Full Court of the Federal Court held that the lack of distributable income meant that there could be no beneficiary of the trust (for the relevant income tax years) to be "*… presently entitled …*'"pursuant to s 97 of the 1936 Act to any amount.

7.11 It should be noted that the Commissioner's subsequent application for special leave to appeal to the High Court was rejected.

7.12 Cajkusic stands for the proposition that the 'distributable income' of a trust is determined by reference to proper accounting principles, as well as the terms of a trust deed. In this context distributable income is income determined according to accounting principles, and which is distributable amongst the beneficiaries. It does not alter either the income as calculated under accounting principles, of the 'net income' as determined under s 95(1) of the 1936 Act – rather, only gives a trustee the power to determine the distributable amounts.

7.13 As a result of the decision in Cajkusic, it is submitted that a trust deed should give a trustee the power to reclassify, and allocate outgoings, so that there can be 'distributable income' to which beneficiaries are presently entitled.

Discretion not to recoup losses (whether income or capital in nature)

7.14 It is recommended that a trustee have a discretion not to recoup losses (whether of an income or capital nature). That is, a power not to recoup losses which have arisen in the past.

8. Resettlement considerations

8.1 Whenever the terms of a trust are varied, an issue to consider is whether the variation amounts to a 'resettlement'.

8.2 Resettlements relate to changes to a trust relationship which have the effect that a new trust estate comes into existence. According to the High Court in *FC of T v Commercial Nominees of Australia Ltd* [2001] HCA 33 (***"*Commercial Nominees"**), the issue to determine is whether '*… what occurred* … [i.e. the variation] … *was a fundamental alteration in the trust relationship*

established by the original deed, such that it destroyed the necessary continuity of the 'taxpayer'…'.

8.3 A resettlement can have significant income tax, capital gains tax (**'CGT'**) and stamp duty consequences, including that:

8.3.1 the trust property may be disposed of, potentially triggering both stamp duty and CGT liabilities;

8.3.2 carried forward tax benefits may be lost; and

8.3.3 beneficiaries may dispose of their interests in the original trust and acquire interest in a new trust.

8.4 Specifically in the context of CGT, a resettlement may cause either CGT event E1 (s 104-60 of the 1997 Act) or CGT event E2 (s 104-65 of the 1997 Act) to happen.

8.5 In August 2001 the issued a Statement of Principles entitled *Creation of a new trust* (the **"Statement**"). The Statement clarifies when, in the Commissioner's view, changes to a trust gives rise to a new trust. The Commissioner considers that a new trust estate arises where there is a 'fundamental change to a trust relationship' – ie, a change in the essential nature and character of the original trust relationship. Further, the Commissioner considers that a new trust (i.e. a resettlement) may arise in the following circumstances:

- a change in beneficial interest in trust property;
- a new class of beneficial interest (whether introduced or altered);
- a redefinition of the beneficiary class;
- changes in the terms of the trust or the rights or obligations of the trustee;
- changes in the nature of the trust property;
- additions of property which could amount to a new and separate settlement;
- depletion of trust property;
- a change in the termination date of the trust;
- a change in the trust that is not contemplated by the terms of the original trust;

- a change in the essential nature and purpose of the trust; and / or
- a merger of two or more trusts or a splitting of the trust.

8.6 The Commissioner considers that depending on their nature and extent, the above changes may either amount to:

8.6.1 a variation of a continuing trust; or

8.6.2 a fundamental change in the essential nature and character of the trust relationship. In such a case, the original trust may be brought to an end and a new trust created. Whether a new trust is created depends on the terms of the original trust and on the powers of the trustee.

8.7 The High Court in Commercial Nominees held that significant changes to a superannuation fund trust deed did not create a new trust, even though the amending deed had:

8.7.1 changed the name of, and appointed a new trustee to the fund;

8.7.2 introduced a new category of beneficiaries;

8.7.3 changed the fund from a defined benefit fund to an accumulation fund;

8.7.4 appointed a professional management company as administrator; and

8.7.5 allowed membership to be promoted to the public.

8.8 The High Court in *Commercial Nominees* considered that there were three main indicators of the continuity of a trust relationship, being:

8.8.1 the constitution of the trust;

8.8.2 the trust property; and

8.8.3 the membership of the trust.

8.9 Substantial changes any of the above may cause a resettlement.

8.10 The High Court considered that, in order to destroy the necessary continuity, changes in one or more of the above indicators must be such as to terminate the existence of the entity, or to produce the result that the particular trust does not derive the income in question. It was held that the changes made to the trust deed in question were not sufficient to destroy the continuity, primarily because the fund was at all times governed by the same deed, the trust property did not change, and the members before the amendment to the trust deed remained members afterwards. We consider that the amendments discussed above will not cause a resettlement.

8.11 The Commissioner notes in the Statement that administrative changes, such as re-defining trust income (without more) may not cause a resettlement (depending on the context) as it may be administrative in nature.

8.12 However, regard will need to be given to the implications to the membership (i.e. the beneficial entitlements) of the trust, and what implications such an amendment will have on the respective entitlements in a trust. For example, an important consideration will be determining how unallocated / undistributed income is to be dealt with. For example, is such income:

8.12.1 accumulated, and form part of the corpus of the relevant trust estate;

8.12.2 is it distributed to certain default beneficiaries; or

8.12.3 is it held on trust for a specific purpose (e.g. a charitable purpose).

Changes in the Taxation of Trusts

A paper presented by Michael Bennett and Denis Barlin at the NSW Young Lawyers CLE

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Michael Bennett E bennett@sevenwentworth.com.au D 8224 3055 M 0408 029 416
Denis Barlin E dbarlin@wenworthchambers.com.au D 9231 6646 M 0404 848 311

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1. General overview

1.1 The income years ended 30 June 2010 and, more particularly, 30 June 2011 have been very active for the taxation of trusts. Significant events in three areas of trust taxplay activity:

1.1.1 decisions of the Courts and principally the High Court's decision in *Commissioner of Taxation v Bamford* (2010) 240 CLR 481; (2010) 264 ALR 436; [2010] HCA 10 ("**Bamford**");

1.1.2 legislative changes, principally:

1.1.2.1 the new rules set out in *Tax Laws Amendment (2011 Measures No. 5) Act* 2011 (Cth) (the "**Streaming Amendments**") that deal with taxation of franking credits and capital gains in trusts; and

1.1.2.2 the new rules set out in the *Tax Laws Amendment (2010 Measures No. 2) Act* 2010 (Cth) that are principally about Division 7A of Part III of the *Income Tax Assessment Act* 1936 (Cth) (the "**1936 Act**") and companies providing rights to use property, but also contain some trust issues (the "**Div 7A Amendments**"); and

1.1.3 Australian Taxation Office ("**ATO**") activities principally the very controversial draft ruling on unpaid present entitlements, TR 2009/D8.

1.2 Some of these changes have overtaken themselves. For instance, there was at the time – and this paper includes – a discussion of streaming post Bamford (see **heading 4** below). That discussion should be read as having been overtaken by the Streaming Amendments (see **heading 5**).

1.3 And what's more the change is not over. Chapter 2 of the explanatory memorandum to the Bill that introduced the Steaming Amendments makes it clear that the streaming provisions have been introduced as an interim measure to deal with perceived anomalies in the taxation of capital gains and franked distributions pending a comprehensive review of Division 6 of Part II of the 1936 Act.

1.4 The changes made so far give rise to issues themselves and further consequential issues for trusts. In addressing the issues – both outlined above and the consequential issues – this paper will discuss:

1.4.1 Taxation of trusts generally;

1.4.2 The competing views before Bamford;

1.4.3 The context of Bamford and what it means for trusts;

1.4.4 Briefly (as it is not germane to the other issues raised in the paper) what are the Div 7A Amendments and what they mean for trusts;

1.4.5 What are the Steaming Amendments and what they mean for trust;

1.4.6 What a trust deed needs in light of those three issues; and

1.4.7 Amending trust deeds to deal with those three issues.

1.5 The issues are dealt with in this order as they are chronological to their occurring.

2. Taxation of Trusts

2.1 The provisions dealing with the taxation of trust income are contained in Division 6 of Part III of the 1936 Act (which comprises of sections 95 to 102).

2.2 As a result of the enactment of Streaming Amendments, regard should also be given to:

2.2.1 Subdivision 207-B of the *Income Tax Assessment Act* 1997 (Cth) (the "**1997 Act**") – which deals with franking credits obtained by a trust estate; and

2.2.2 Subdivision 115-C of the 1997 Act – which deals with the distribution of capital gains by a trust estate.

2.3 Chief Justice Latham in *Tindal v FC of T* (1946) 72 CLR 608 at 618 observed that the object of Division 6 of the 1936 Act is to "*… secure payment of tax upon the whole of the net income of a trust estate, either from a beneficiary or the trustee, whether the income is paid over to or on account of the beneficiary …*". Further, according to Emmett J in *Bamford v Federal Commissioner of Taxation* (2009) 176 FCR 250 "*… an important assumption underlying Division 6 …* [is] *… that a beneficiary who derives a share of the net income should be in a position to pay out of that income; otherwise, the beneficiary could be placed in a difficult position*."

2.4 The starting point in determining the taxation of trust income is s 97 of the 1936 Act. Relevantly, s 97(1) of the 1936 Act 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; and

(b) the exempt income of the beneficiary shall include:

(i) so much of the individual interest of the beneficiary in the exempt income of the trust estate as is attributable to a period when the beneficiary was a resident; and

(ii) so much of the individual interest of the beneficiary in the exempt 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;

except to the extent to which the exempt income to which that individual interest relates was taken into account in calculating the net income of the trust estate; and

(c) the non-assessable non-exempt income of the beneficiary shall include:

(i) so much of the individual interest of the beneficiary in the non-assessable non-exempt income of the trust estate as is attributable to a period when the beneficiary was a resident; and

(ii) so much of the individual interest of the beneficiary in the non-assessable non-exempt 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]

2.5 That is, s 97 of the 1936 Act provides that where a beneficiary, who is not under a legal disability is presently entitled to a "*… share of the income of the trust estate …*", the assessable income of:

2.5.1 a resident beneficiary includes the beneficiary's share of the '*… net income of the trust estate …*'; and

2.5.2 a non-resident beneficiary includes so much of the beneficiary's share of the net income of the trust as is attributable to sources in Australia.

2.6 It should be noted that the term "net income of the trust estate" for the purposes of s 97 of the 1936 Act is defined in s 95(1) of the 1936 Act. However, the term "*… the income of the trust estate …*" as contained in s 97 of the 1936 Act is not defined in the 1936 Act.

2.7 Subsection 95(1) of the 1936 Act defines the term 'net income', in relation to a trust estate as:

> ***net income**, 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 Division 393 of the Income Tax Assessment Act 1997 (Farm management deposits) 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.*

2.8 For completeness, it should be noted that:

2.8.1 s 98 of the 1936 Act provides that the trustee is liable to tax on behalf of a beneficiary where the beneficiary is presently entitled to a share of the income of a trust estate, but the beneficiary is under a legal disability;

2.8.2 ss 99 and 99A of the 1936 Act apply to subject the trustee to tax where there is some part of the net income of a trust estate that is not subject to tax under either of ss 97 or 98 of the 1936 Act. The difference as between s 99 and s 99A of the 1936 Act is the rate of tax applicable. Typically, the trustee will be subject to tax under section 99A of the 1936 Act at a penal rate of tax equal to the maximum rate of tax (currently 45%). However, the Commissioner has a discretion to apply s 99 of the 1936 Act in certain circumstances, in which case the trustee will be subject to tax at the normal marginal rates of tax.

3. The two competing views before the decision in Bamford

3.1 There has been, for some time, two competing views in the taxation of trust income – the proportionate view and the quantum view.

Proportionate approach

3.2 *David & Anor v FC of T* 89 ATC 4377 contains an example of the application of the proportionate approach (which according to the High Court's decision in Bamford, is the correct approach).

3.3 The proportionate view looks to the share (or proportion) of trust law income of a trust to which a beneficiary is "presently entitled", and then applies that share or proportion to the net income of a trust estate to calculate how much of the net income is to be included in the beneficiary's assessable income.

3.4 As an example, if a beneficiary is entitled to one half of the trust law income, then the beneficiary must include half of the net income in their assessable income – irrespective of whether it is more or less than the amount of the trust law income to which they are entitled.

(a) Implications if tax law income exceeds trust law income

3.5 Under this approach, a beneficiary who is "presently entitled" to trust law income may be required under s 97(1) of the 1936 Act to include in their assessable income an amount of net income which is greater than the amount of trust law income to which they are entitled, and to which has been paid or distributed to them.

3.6 That is, they may be subject to tax on amounts whish they will not receive, and are not entitled to actually receive.

3.7 This outcome seems to be contrary to the objectives of Division 6 of the 1936 Act as outlined by Emmett J in the Full Court of the Federal Court decision in *Bamford v Federal Commissioner of Taxation* (2009) 176 FCR 250 (discussed above).

(b) Implications if trust law income exceeds tax law income

3.8 However, where the net income of a trust estate for the purposes of s 95(1) of the 1936 Act is less than the trust law income, then a beneficiary who is "presently entitled" pursuant to s 97(1) of the 1936 Act will be required to include in their assessable income an amount which is less than the trust law income to which they will be entitled, and which will be paid to them.

3.9 As a result, an on the assumption that the beneficiaries are "presently entitled" to the whole of the trust law income, with the result that the whole of the "net income" of the

trust estate is included in their assessable income pursuant to s 97(1) of the 1936 Act, there can be no part of the net income to which ss 99 or 99A of the 1936 Act applies.

3.10 There is still a question as to whether, in these circumstances, the beneficiary must include the excess amount (i.e. the amount not included under s 97(1) of the 1936 Act) under some provision of the tax acts (e.g. CGT event E4 as contained in s 104-70 of the 1997 Act).

The quantum approach

3.11 The quantum approach (which is no longer good law) is based on the proposition that a beneficiary can only be presently entitled to such amount(s) of trust income as they actually receive.

3.12 Further, any part of the net income of the trust estate which exceeds the amount to which the beneficiary is presently entitled is not income to which the beneficiary is presently entitled to pursuant to s 97 of the 1936 Act, with the result that the trustee is subject to tax on it under s 99A of the 1936 Act (unless the Commissioner exercises it discretion to cause it to be subject to tax under s 99).

3.13 As with the proportionate approach, where the net income of the trust estate for s 95(1) of the 1936 Act purposes is less than the trust law income, such that the beneficiary receives an amount which is greater than the amount included in their assessable income, the question arises as to how the excess is to be taxed (if at all).

4. Bamford

4.1 Bamford was a much anticipated decision. In the view of some[1] the decision was a missed opportunity to settle an area of the trust law and tax law that has been crying out for correction: *Bamford* at [17] citing Hill J in *Davis v Federal Commissioner of Taxation* (1989) 86 ALR 195 at 230.

Background to Bamford

4.2 Mr and Mrs Bamford were beneficiaries of a discretionary trust known as the Bamford Trust (the "**Trust**"). The trustee of the Trust was P&D Bamford Enterprises Pty Ltd. Mr and Mrs Bamford were also the directors and employees of P&D Bamford Enterprises Pty Ltd.

[1] Slater QC *Taxation Trust Income After* Bamfor'ds *Case*, 26th National TIA Convention, 2-4 March 2011

4.3 During the 2000 income tax year, the Trust made a contribution to an offshore superannuation fund on behalf of Mr and Mrs Bamford. The contribution was sourced from borrowings by the corporate trustee, in its capacity as trustee of the Trust.

4.4 For the purposes of determining the "net income" of the Trust for the 2000 income tax year, the corporate trustee (in its capacity as trustee of the Trust) claimed a deduction for both the contribution made to the offshore superannuation fund, and the interest on the borrowed funds used to make the contribution. The total deduction claimed was $191,701.

4.5 After taking into account of the deductions, the "net income" of the Trust for that year was distributed to specified beneficiaries of the Trust. Included in the distribution were Mr and Mrs Bamford, who both had specified amounts distributed to them.

4.6 Specifically, for that income tax year (i.e. the 2000 income tax year), the trustee of the Trust allocated amounts to certain beneficiaries of the Trust, including a payment of $34,000 each to Mr and Mrs Bamford. However, the trustee of the Trust did not have sufficient funds to pay the full amount of $34,000, and instead paid them $33,872, being what the trustee of the Trust thought was the total remaining trust funds.

4.7 The amount initially distributed by the trustee of the Trust was $187,530.

4.8 In 2005, the Commissioner of Taxation applied the anti-avoidance provisions so as to disallow the deductions of the Trust (for the 2000 income tax year) for the superannuation contribution and the interest. As a result of the denial of the deductions, for the purposes of the 2000 income tax year the Trust's taxable income exceeded its accounting income.

4.9 The decision essentially dealt with two things:

4.9.1 whether the 'proportionate approach' applied in the event that tax law income exceeds accounting / trust income; and

4.9.2 whether the trust deed of the trust could characterise an amount of capital gains as income of the Trust.

Application of the proportionate view

4.10 As a result of the denial of the deduction, the Trust's taxable income increased by $191,000. The Commissioner issued amended income tax assessments to both Mr and Mrs Bamford. Pursuant to the assessments, the Commissioner contended that Mr and Mrs Bamford were liable to tax on the increased 'net income' of the Trust based on the proportionate share of the amount by which the taxable income of the trust exceeded the accounting income.

4.11 Indeed, the Commissioner sought to assess Mr and Mrs Bamford on an extra $34,624, on the basis that that amount represented the 'share' of the additional $191,000 as their share (i.e. 18%) of the previous amount (i.e. $187,530) actually distributed.

4.12 However, the taxpayers argued that they should only be taxed on the difference between the $33,872 which they actually received, and the specific amount of $34,000 which was originally allocated to them (i.e. an amount of $128 each).

4.13 The High Court rejected the taxpayer's argument, and in doing so applied the "proportionate approach".

4.14 The High Court took a two step approach in dealing with this issue:

4.14.1 First – the High Court held that the term "*… income of the trust estate …*" as contained in s 97(1) of the 1936 Act refers to distributable income, being income as determined by the trustee taking into account the terms of the trust (e.g. the trust deed) and appropriate accounting principles.

4.14.2 Secondly – after ascertaining the "share" of the distributable income to which a beneficiary is presently entitled, s 97(1) of the 1936 Act then requires that "*… that share of the net income of the trust estate …*" be ascertained, being the shares of the taxable income and not the distributable income.

4.15 Further, it was held that the inclusion within s 97(1) of the 1936 Act of the defined phrase "*… net income of the trust estate …*" and the undefined term "*… the income of …* [the] *… trust estate …*" indicated that these were intended to have different meanings. As a result, the term "*… the income of …* [the] *… trust estate* " had a different and defined meaning for taxation purposes.

4.16 The Court at [45] held that the analysis of Sundberg J in *Zeta Force Pty Ltd v Commissioner of Taxation* (1998) 84 FCR 70 at 74-75 should be applied:

> *The resolution of the second issue of construction is to be found in the analysis by Sundberg J in* Zeta Force Pty Ltd v Commissioner of Taxation *… . His Honour dealt with the first issue of construction to the same effect as that just explained, saying:*
>
> > *"The words 'income of the trust estate' in the opening part of s 97(1) refer to distributable income, that is to say income ascertained by the trustee according to appropriate accounting principles and the trust instrument. That the words have this meaning is confirmed by the use elsewhere in Div 6 of the contrasting expression 'net income of the trust estate'. The beneficiary's 'share' is his share of the distributable income."*
>
> *Sundberg J then continued:*
>
> > *"Having identified the share of the distributable income to which the beneficiary is presently entitled, s97(1) requires one to ascertain 'that share of the net income of the trust estate'. That share is included in the beneficiary's assessable income. The expression 'net income of the trust estate' in par (a)(i) has the meaning given it by s 95(1) – taxable income as opposed to distributable income. The words 'that share' in par (a)(i) refer*

back to the word 'share' in the expression 'a share of the income of the trust estate', and indicate that the same share is to be applied to an income amount calculated according to a different formula (taxable income as opposed to distributable income). Since the income amount may differ according to which formula is applied, the natural meaning to give to 'share' where it appears for the second time is 'proportion' rather than 'part' or 'portion'. When Parliament wanted to convey the latter meaning, as it did in ss 99 and 99A, it used the word 'part'.

The contrast between the expressions 'share of the income of the trust estate' and 'that share of the net income of the trust estate' shows that the draftsman has sought to relate the concept of present entitlement to distributable income, and not to taxable income, which is, after all, an artificial tax amount. Once the share of the distributable income to which the beneficiary is presently entitled is worked out, the notion of present entitlement has served its purpose, and the beneficiary is to be taxed on that share (or proportion) of the taxable income of the trust estate."

4.17 For the 2000 income year, the "net income" of the Trust included the amount of $191,701 which should not have been claimed as a deduction in the tax return of the Trust. As a result, the High Court held that the assessable income of Mr and Mrs Bamford should include a share of that amount, equivalent to the share they each received of the distributable income.

Whether the trust deed could re-characterise amounts

4.18 The trust deed of the Trust gave the trustee the discretion to determine whether a particular receipt should be treated as income or capital.

4.19 The trustee relied on this power to pass a resolution to distribute the first $60,000 of net income, "*… including …* [the] *…. capital gain …*" to Mr and Mrs Bamford in equal shares.

4.20 The Commissioner argued that the capital gain was not income of the Trust. Further, since there was no income, no beneficiary could be 'presently entitled' to the amount in question, the trustee of the Trust should be assessed at the special rates.

4.21 The High Court held that the term "income" as contained in s 99A of the 1936 Act should be interpreted as income of the trust estate, as understood in trust law.

4.22 As a result, the net capital gain of the Trust became the income of the Trust after the trustee exercised its discretion to characterise the capital gain as income of the Trust.

Outcome for Trust Distributions

4.23 There is no room for doubt that Bamford establishes that:

4.23.1 income of the trust estate identified in s 97(1) of 1936 Act is to be determined according to any directions set out in the Trust Deed;

4.23.2 the share of the net income attributable to a beneficiary is to be determined in the same proportions in which the beneficiary enjoys the present entitlement to the share of the income of the trust.

4.24 In this first regard, the Court made it clear that the general rules regarding apportionment between capital and income of receipts and outgoings was largely based on assumptions which could be displaced by the terms of the trust instrument: Bamford at [17]. The general law of trusts operates to give meaning to the term "the income of the trust estate".

4.25 The determination of present entitlement to a share of the income is a process of trust administration. The decision of the Full Court of the Federal Court in *C of T v Totledge Pty Ltd* (1982) 40 ALR 385 at 393 is quoted in support: Bamford at [39]. The High Court distinguished its own decision in *C of T v Australia and New Zealand Savings Bank Ltd* (1998) HCA 53 (Bamford at [39]) as not relevantly addressing the issue. Finally, the Court observed that the Commissioner's lack of consistency in wishing to exclude "statutory income" from "income of the trust estate" did not assist his argument that "income" means "income according to ordinary concepts": Bamford at [41].

4.26 On the meaning of the term "share of the net income" the High Court adopted the proportionate approach advocated by Sunberg J in *Zeta Force* (discussed above).

4.27 What does this translate into for trustees making decisions in respect of trust distributions for the 2010 income year?

4.28 There are a number of relevant observations to be made.

4.29 First, if the Trust Deed provides a formula for determining the income of the trust then that formula will determine the entitlement of the beneficiaries to income. If, for example, the Deed contains words to the following effect:

> *"The net income of the trust is an amount equal to the amount determined in accordance with subsection 95(1) of the* Income Tax Assessment Act 1936 *but reduced by any amount which would otherwise be included by application of Division 207 of the* Income Tax Assessment Act 1997*".*

4.30 Throughout this paper "subsection 95(1) terms" means an amount adjusted for the franking credit gross up. The issue of grossing up is considered below in the context of using the full tax exemption including the franking rebate available to children.

4.31 Leaving aside the elimination of any gross up for franking credits (which itself is affected by the Streaming Amendments as discussed below) the amount of net income for trust law purposes

will equal the tax law income. The two will coincide so that there should, in the ordinary course, be no amount assessable to the trustee under s 99A of the 1936 Act.

4.32 Secondly, if the Trust Deed is silent then "ordinary income" principles apply. Just what they are is difficult to say. The ATO has expressed the view that income of a trust is income according to ordinary principles. This is not the same thing as accounting income determined in accordance with accounting principles. It requires a dissection of receipts into:

4.32.1 income according to ordinary principles;

4.32.2 income which is not ordinary income;

4.32.3 capital receipts.

4.33 Following that dissection, the expenses must be apportioned accordingly.

4.34 This is, of course, all too much. Many trust deeds will have a clause like that in Bamford which allows the trustee to determine whether a receipt is capital or income. Others will have very broad powers allowing the trustee to determine the basis on which income of the trust is to be worked out.

4.35 If these powers exist they should be used to avoid uncertainty brought about by the "ordinary income" approach. If they do not exist then the deed should be to give the trustee such a power. Whether such an amendment will amount to a resettlement, which might have adverse capital gains tax (and stamp duty) consequences, is discussed at **paragraphs xx** below.

4.36 Thirdly, because the proportionate approach has prevailed, a strict application of that rule will mean that great care needs to be taken when seeking to direct a specific amount of tax law net income to a particular beneficiary with absolute certainty e.g. the maximum amount to a child which escapes the punitive rates under Division 6AA of the 1936 Act. This issue is illustrated in the Examples which follow.

4.37 Fourthly, the High Court decision says nothing about streaming of trust income. The matter was not in issue. The uncertainty about streaming of income according to its character remained unabated, until the Streaming Amendments.

4.38 Finally, the ATO has done away with the benevolent "capital beneficiary" approach set out in Practice Statement PSLA 2005/1 (GA) on and from 13 October 2010.

Examples

4.39 The best way to illustrate these points is by way of example. In the examples which follow the following facts apply in relation to the A Family Trust for the income year ended 30 June 2010:

Receipts:

rent	$50,000
net capital gain	$100,000

Expenses:

rental expenses	$10,000
interest	$20,000

4.40 The interest relates to the rental property only. The discountable capital gain was made on the sale of shares in a listed company. The intended beneficiaries are Mr and Mrs A and their two children both under 18.

4.41 Because of the low income rebate the following no-tax thresholds apply to minors:

Income Year end 30 June	**$**
2010	3,000
2011	3,333

4.42 If the income constitutes fully franked dividends the cash payment thresholds and grossed up taxable income amounts are:

Income Year end 30 June	**$ cash**	**$ taxable income**
2010	6,300	9,000
2011	7,000	10,000

4.43 These figures have considerable significance for trustees seeking to hit the no tax "sweet spot" for a distribution to a child.

(a) Subsection 95(1) terms apply – no "balance approach"

4.44 The taxable capital gain is $50,000. Accordingly, the distributable trust income is $70,000.

4.45 For 2010 a minor may be distributed $3,000 with no tax liability if entitled to the low income rebate (see comments above).

4.46 The trust distribution minutes might give effect to the following:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000

70,000

4.47 The tax law results will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.48 The cash in the trust will include the $50,000 covered by the 50% general CGT discount. This is not income and can be dealt with as capital. As this is a discretionary trust it can be distributed without tax consequences.

(b) Ordinary income applies – no "balance approach"

4.49 In this instance the trust distribution minutes will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	7,000
Mr A	7,000
	20,000

4.50 The tax law results will be:

	$
Child 1	$3{,}000 + {}^{3,000}/_{20,000} \times \$50{,}000$
Child 2	$3{,}000 + {}^{3,000}/_{20,000} \times \$50{,}000$
Mrs A	$7{,}000 + {}^{7,000}/_{20,000} \times \$50{,}000$
Mr A	$7{,}000 + {}^{7,000}/_{20,000} \times \$50{,}000$

4.51 The final results:

	$
Child 1	10,500
Child 2	10,500
Mrs A	24,500

Mr A	24,500
	70,000

4.52 This is a strict application of the proportionate approach.

4.53 Each of the children will pay tax on $7,500 at the Division 6AA punitive rates of 45%. This is not a good result.

(c) Subsection 95(1) applies – "balance approach" used

4.54 Trust minutes:

	$
Child 1	3,000
Child 2	3,000
Mrs A	half of the balance
Mr A	half of the balance

4.55 Trust income entitlements:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.56 The tax law result:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.57 This is the same outcome as where no "balance approach" is applied – but see below for the effect of a tax adjustment.

(d) Ordinary income applies – "balance approach" used

4.58 Trust minutes

	$
Child 1	3,000
Child 2	3,000
Mrs A	half of the balance
Mr A	half of the balance

4.59 Trust income created will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	7,000
Mr A	7,000
	20,000

4.60 The tax law results will be:

	$
Child 1	$3{,}000 + {}^{3,000}/_{20,000} \times \$50{,}000$
Child 2	$3{,}000 + {}^{3,000}/_{20,000} \times \$50{,}000$
Mrs A	$7{,}000 + {}^{7,000}/_{20,000} \times \$50{,}000$
Mr A	$7{,}000 + {}^{7,000}/_{20,000} \times \$50{,}000$

4.61 The final results:

	$
Child 1	10,500
Child 2	10,500
Mrs A	24,500
Mr A	24,500
	70,000

4.62 Again there is no difference. However, the "balance approach" is more realistic because it is unlikely that the trust income or tax law income will be known as at any 30 June. In reality these figures are not known until the accounts are drawn later in the calendar year.

(e) Tax Law Adjustments

4.63 It is often important to anticipate an adjustment to the trust's tax law income especially where there is something contentions going on.

4.64 As has been seen the tax law result will follow on a proportionate basis the entitlements to income created under the Deed. To test the outcome it is assumed in the above examples that the trustee failed to recognise $10,000 of rental income (say the trustee at first considered that the income was to be deferred until the 2011 income year) but was in fact wrong about this.

4.65 How do the various approaches deal with such an adjustment?

Example (a) – subsection 95(1) applies (but no "balance approach")

4.66 The trust law entitlements and tax law results were the same:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.67 The tax law adjustment will increase both the trust law entitlement and the tax law income by $10,000. The Trustee has not dealt with this $10,000 and, without an operative default beneficiary clause, it will be assessed to the Trustee under section 99A of the 1936 Act.

4.68 The trust law entitlements and tax law result will be:

	$
Child 1	3000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
Trustee	10,000
	80,000

4.69 However, if there is no streaming of the capital gain (with the effect that all beneficiaries are entitled to a proportionate part of the capital gain) that part of the capital gain reflected in the income to which no beneficiary is presently entitled will be grossed up for the loss of the 50% general CGT discount. Five eighths of the $10,000 adjustment assessed to the Trustee is capital gain. As a result the share of the net income assessable to the Trustee will be increased by $6,250.

4.70 The final result will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
Trustee	16,250
	86,250

4.71 This is a costly outcome.

Example (c) – subsection 95(1) but using a "balance approach".

4.72 The trust law entitlement and tax law result were the same.

	$
Child 1	3,000
Child 2	3,000
Mrs A	half of the balance
Mr A	half of the balance

4.73 The unadjusted result was:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.74 The adjusted trust law entitlement and tax law result will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000 + 5,000
Mr A	32,000 +5,000
	80,000

4.75 The "balance approach" together with adoption of s 95(1) terms directs all of the tax law result from an adjustment made by the ATO to the balance beneficiaries.

4.76 If the balance distribution has been used Mr and Mrs A will "enjoy" a further $5,000 of income entitlement (it now having been correctly determined) and a further $5,000 of tax law net income each. No amount will be assessed to the trustee.

4.77 There is an argument that the beneficiaries have not become presently entitled to the amount of the adjustment to the trust law net income as it was not ascertained at the end of the income year. In the writer's opinion the trust law net income was always the amount as correctly adjusted by the ATO. There was never any uncertainty about it. It is simply the case that the trustee and ATO had not properly determined the correct quantum of income.

4.78 In practical terms how have the Courts looked at the "balance approach"? It has not come up that often.

4.79 The decision of Cooper J in *BRK (Bris) Pty Ltd v C of T* [2001] FCA 164 might at first blush give cause for concern. There the Court considered the operation of the default beneficiary clause in the Trust Deed. The distributions had been:

1993 income year:

"Hendon Unit Trust 100%

and Resolved that should the Commissioner of Taxation disallow any amount as a deduction or include any amount in the assessable income of the Trust, such amount or amounts are to be deemed distributed on 30th June 1993 in the same proportions as listed above to the beneficiaries listed above".

1994 income year:

(a) The sum of $304,021.72 to Westside Commercial Centre Pty Ltd as trustee of the Hendon Unit Trust for its absolute benefit.

(b) The following sums to the following beneficiaries for their absolute respective benefits: NIL

(c) The Balance to Jessica Wagner and Bill Wagner equally between them for their absolute benefit.

1995 income year:

Hendon Unit Trust	*First $220,000*
Northbourne Trust	*Next $100,000*

Wilhelm J Wagner and Jessica O Wagner	*Remainder of balance equally*

4.80 The same "variation of income" clause as in 1993 applied in this year.

4.81 It would appear that the Trust Deed did not adopt subsection 95(1) terms and that income was ordinary income.

4.82 It was found that the Hendon Unit Trust was not an object of the Trust and the distribution of income to it failed. The default beneficiaries clause distributed income in default of appointment to the beneficiaries described in the Schedule to the Deed as tenants in common. This was the usual wide class of family objects.

4.83 The Court concluded that the default beneficiary clause did not operate as at 30 June because the trustee had a reasonable time after the end of the income year in which to decide to distributed or accumulate.

4.84 The question arose as to whether the balance clause in the 1994 and 1995 determinations operated to take the amounts which the Trustee had attempted to distribute to the Hendon Unit Trust to Mr and Mrs Wagner. It was concluded that this was not the effect of the distribution minute and, as a result, the Trustee was assessable under section 99A.

4.85 At [40] Cooper J concluded:

> *"In my judgment the submission is misconceived. In the 1994 income year the clear intention of the applicant was to appoint to Mr and Mrs Wagner only so much of the Trust income, if any, as exceeded $304,021.72 in addition to any income in excess of that amount in the event that the appointment to WCC should fail. The position is no different in respect of the 1995 year. The trustee purported to appoint discrete amounts of income to the Hendon Unit Trust as to the first $220,000 and to the Northbourne Trust as the next $100,000. Finally, as to any remainder after the application of the first $320,000 of income, that remainder was to be appointed to Mr and Mrs Wagner; they did not as a matter of construction or intention on the part of the trustee, take by default all of the income in the event of failure of the other two appointments."*

4.86 Rather than being a cause for concern about the "balance approach" the decision of Cooper J on this point supports its operation. The specific quantum entitlements fix the income (and tax where s 95(1) terms apply) at the amount specified in the Trustee's determination. If the gift fails it does not flow to the balance beneficiary but to the default beneficiary or, in the alternative, there is no such entitlement created, giving rise to a s 99A assessment to the trustee.

4.87 Further comfort can be obtained from observations made in *C of T v Ramsden* [2005] FCAFC 39. In that case the Court was concerned with the issue whether a beneficiary had effectively renounced a distribution of income.

4.88 The distribution minutes for the 1996 income year provided:

"Steve Hart Family Holdings No.2	*$17,295*
Steve Hart Family Holdings No.3	*$6,639*
Unlimited Aerobatic Discretionary Trust	*$34,810*
The Adcock Practice Trust	*$429,000*
Troy B Hart	*$4,750*
Steven I Hart	*The Balance"*

4.89 It was agreed that the Adcock Practice Trust did not qualify as a beneficiary. The default beneficiary clause provided for income which had not been appointed prior to year end to be held for Steven Hart and his three children as tenants in common. The ATO assessed each of the default beneficiaries to one quarter of the amount which had failed to be appointed to the Adcock Practice Trust.

4.90 The argument was pressed before the primary judge that the income should pass by way of the balance distribution to Steven Hart: Ramsden at [38] to [41]. Justice Spender's rejection of this argument was confirmed by the Full Court. It was observed at [2005] FCAFC 39 at [72]:

> *"We agree with this construction. 'The Balance' does not include the amounts which precede "The Balance" in the resolution of 30 June 1996.*
>
> *'The Balance' is the Income of the Trust for the year ended 30 June 1996 other than the amounts which precede it in the resolution in question, whether effectively appointed or not".*[2]

4.91 This observation supports the "balance approach" taken in this paper where there have been effective distributions. Note, however, that it will not work where a distribution is ineffective. In such a case the adjustment will be assessed to the default beneficiary, if there is one, or to the trustee.

Example (d) – Ordinary Income with balance approach applying

4.92 The trust law entitlements were:

	$
Child 1	3,000

[2] [2005] FCAFC 39 at para. 72.

Child 2	3,000
Mrs A	half of the balance
Mr A	half of the balance

4.93 Trust income entitlements:

	$
Child 1	3,000
Child 2	3,000
Mrs A	7,000
Mr A	7,000
	20,000

4.94 The tax law result was:

	$
Child 1	10,500
Child 2	10,500
Mrs A	24,500
Mr A	24,500
	70,000

4.95 When the tax law income is adjusted by $10,000 there is no change to the trust law result. The tax law result will be:

	$
Child 1	$10,500 + {}^{10,500}/_{70,000} \times \$10,000$
Child 2	$10,500 + {}^{10,500}/_{70,000} \times \$10,000$
Mrs A	$24,500 + {}^{24,500}/_{70,000} \times \$10,000$
Mr A	$24,500 + {}^{24,500}/_{70,000} \times \$10,000$

4.96 The final result will be:

	$
Child 1	12,000
Child 2	12,000
Mrs A	28,000
Mr A	28,000

	80,000

4.97 The result has only become worse from a Division 6AA income perspective.

Will a "default beneficiary" clause in the Deed assist?

4.98 An income default beneficiary clause would be expressed something like:

> *"If the Trustee has not determined to distribute all of the net income of the Trust by the end of the Income Year the Income Default Beneficiary will be absolutely entitled to that part of the net income which has not been distributed."*

4.99 The term "Income Default Beneficiary" will be appropriately defined to identify individuals or companies.

4.100 In Example (a) – subsection 95(1) terms but no "balance approach" – a default beneficiary clause would have deflected the tax adjustment from the trustee to the default beneficiary.

4.101 In Example (b) – ordinary income but no "balance approach" – the default beneficiary clause would have no effective operation as all of the trust law/tax law income has been accounted for.

4.102 The trust entitlements were:

	$
Child 1	3,000
Child 2	3,000
Mrs A	7,000
Mr A	7,000
	20,000

4.103 The tax law result was:

	$
Child 1	10,500
Child 2	10,500
Mrs A	24,500
Mr A	24,500
	70,000

4.104 If the tax law income is increased by $10,000 the trust law income does not alter. The tax law adjustment is apportioned according to the trust law income apportionments, as follows:

	$
Child 1	10,500 + $^{3,000}/_{20,000}$ x 10,000
Child 2	10,500 + $^{3,000}/_{20,000}$ x 10,000
Mrs A	24,500 + $^{7,000}/_{20,000}$ x 10,000
Mr A	24,500 + $^{7,000}/_{20,000}$ x 10,000[3]
	70,000

4.105 The final tax results will be:

	$
Child 1	12,000
Child 2	12,000
Mrs A	28,000
Mr A	28,000
	80,000

4.106 In Example (c) – subsection 95(1) terms and a "balance approach" – the default beneficiary clause has no role to play because the adjustment will always be directed to the balance beneficiary.

4.107 In Example (d) – ordinary income and "balance approach" – the default beneficiary clause has no need to operate because the tax adjustment will simply be apportioned in accordance with the trust law entitlements which don't change.

Summary re Tax Adjustments

Trust Accounting Basis	Tax Law Income	Trust Income	Adjustment to (if no default beneficiary)	Adjustment to (if there is a default beneficiary)
subsection 95(1) – no "balance approach"	+ $100	+ $100	Trustee	Default Beneficiary
subsection 95(1) – "balance approach"	+ $100	+ $100	Balance Beneficiaries	Balance Beneficiaries
ordinary income – no "balance approach"	+ $100	no change	All Beneficiaries	All Beneficiaries
ordinary income – "balance approach"	+ $100	no change	All Beneficiaries	All Beneficiaries

[3] The proportions remain the same whether the trust law or tax law results are used.

Guidance from Bamford

4.108 As the High Court observed in Bamford at [17]:

> *"… both sides in argument on the present appeals accepted that whichever of the competing constructions of Div 6 were accepted examples could readily be given of apparent unfairness in the resulting administration of the legislation"*

4.109 In reaching the conclusion that the terms of the Trust Deed determine the trust income to which a beneficiary may be made entitled the High Court has gone very far towards resolving most of the problems and uncertainties which confronted practitioners and the trustees and beneficiaries they advise. With a good understanding of the terms of the Trust Deed as they effect trust distributions most distribution problems can be addressed.

4.110 As has been demonstrated in the above worked examples adopting a s 95(1) terms plus "balance approach" achieves the following:

4.110.1 the quantum of tax distribution to children can be locked in.

4.110.2 any "normal" tax adjustment will flow to the balance beneficiaries.

4.110.3 if used in conjunction with a default beneficiary clause ineffective distributions can also be dealt with.

4.111 The subsection 95(1) but without a "balance approach" can lead to:

4.111.1 an assessment of the tax adjustments to the trustee under section 99A;

4.111.2 clawback of any general CGT discount.

4.112 This can be addressed by using a default beneficiary (of course the default beneficiary should not be a company where the general CGT discount is involved).

4.113 The balance approach together with a considered default beneficiary is to be preferred as the outcome is more predictable.

4.114 The ordinary income approach is problematic because it is:

4.114.1 too difficult to calculate what is net ordinary income;

4.114.2 and tax law adjustments will be spread across all beneficiaries (as there is no adjustment to the net income).

5. Div 7A Amendments

5.1 Division 7A of Part III of the 1936 Act deals with accessing wealth in private companies without accounting for the tax that would otherwise be payable on the value accessed. It focuses on three means of accessing wealth in private companies – payments from a private company, loans from a private company or the forgiveness of a debt by a private company to an associate of that company.

5.2 In 2010 there were two broad changes to the Division 7A interacts with trusts:

5.2.1 The Div 7A Amendments; and

5.2.2 The Commissioner's position in *Taxation Ruling 2010/3* and *Practice Statement Law Administration* 2010/4.

5.3 The changes to Division 7A include the insertion of an introductory note to Division 7A stating:

> An amount may also be included in the assessable income of a shareholder or shareholder's associate if:
>
> (a) a company has an unpaid present entitlement to income of a trust; and
>
> (b) the trustee makes a payment or loan to, or forgives a debt of, the shareholder or associate.
>
> (See Subdivisions EA and EB.)

5.4 This note is of interest as it strongly suggests that Subdivision EA is a 'code' which is intended to capture arrangements where there is an unpaid present entitlement subsisting between a trust and a corporate beneficiary and there is then a loan, payment or forgiveness that occurs between the trustee and a shareholder or an associate of a shareholder in the corporate beneficiary.

5.5 This should be contrasted with the position in the ATO *Taxation Ruling* 2010/3 where the ATO assert that subdivision EA has much more limited effect, where they generally restrict its operation to the situation where there is a sub-trust in existence between a trustee and a corporate beneficiary and there is then loan, payment or forgiveness involving a shareholder or an associate of a shareholder and the trustee of the sub-trust.

5.6 In the 31 March 2010 NTLG meeting the professional bodies questioned the ATO as to whether the introduction of this provision into Division 7A cast doubt on the position in their draft ruling. The meeting agenda includes the following discussion:

> The ATO does not see a conflict between the legislation of provisions dealing with unpaid present entitlements and the position set out in Draft Ruling TR 2009/D8.

This is because, contrary to the premise of the question, under Draft Ruling TR 2009/D8 unpaid present entitlements will retain that status for Division 7A purposes in many situations, including where:

- the amount representing the UPE is physically held on sub-trust for the sole benefit of the private company beneficiary;
- the amount representing the UPE is being used by the trustee but all benefits from this use are held for the sole benefit of the private company; or
- the private company beneficiary is not aware and cannot be taken to be aware that the funds representing its UPE are being used for the potential benefit of any or all discretionary objects of the trust (rather than being physically set aside or used for its sole benefit).

The ATO has appropriately consulted with Treasury prior to and during the drafting of TR 2009/D8.

Provisions within Division 7A dealing with unpaid present entitlements will continue to have their intended application and there is no inconsistency between the Exposure Draft legislation and the draft Ruling.

Use of assets

5.7 As was announced in the 2009/10 Federal Budget the use of assets owned by private companies, or owned by trusts where there is a present entitlement owing to a private company may be subject to tax after 1 July 2009.

5.8 The way in which the use of assets will become subject to tax is through the amendment of the definition of the term 'payment' in Division 7A so that it extends to the provision of an asset (other than a transfer of property) for use by an entity. Consistent with the present operation of Division 7A the provision of the asset will only result in Division 7A consequences where the asset is provided to a shareholder or associate of a shareholder.

5.9 For the purposes of Division 7A the payment will occur when the use of the asset occurs.

5.10 A payment will also arise however where the asset is not used, but is available for use. The examples in the EM are illustrative of when it will be the right to use the asset, and not its use, that is subject to the Division 7A rules.

> ***Example (right to use from EM)***
> ***Brian is a shareholder of a private company that owns a luxury yacht. He does not have a formal agreement with the company in relation to the yacht, however, he takes the yacht out every second weekend.***
>
> ***Brian keeps the yacht at the company's business premises, but takes the key home. Brian stores several personal items on the yacht.***
>
> ***Brian's fortnightly use of the yacht is a payment under Division 7A. The availability of the yacht for Brian's use is also subject to Division 7A because the yacht is not readily available for use by the company. The company would need to arrange with Brian to***

get the key and for the removal of Brian's personal items before using the yacht. That is, the asset is available for Brian's use to the exclusion of the company.

Example (use from EM)
Marina is a shareholder of a private company that owns a city apartment. The apartment is generally available for rent. However, Marina asks the company not to rent the apartment out for a week so that she and her family can use the apartment over a long weekend. Marina's use of the apartment is a payment for the purposes of section 109CA.

5.11 An issue that arose on consultation over the draft legislation giving effect to these changes was whether the mere availability of assets to a shareholder or associate would result in the shareholder or associate being treated as having the asset available for their use. The EM again includes an example where there a payment is not taken to arise where an asset is available as a result of a general entitlement to use an asset without actual use of the asset.

Example (mere entitlement from EM)
Peter is a shareholder of a private company that owns five cars for company use. Shareholders and their associates have general permission to use the cars on weekends if they are not being used for company business. Peter regularly takes one of the cars home.

Peter's use of the car that he takes home will be subject to Division 7A. This will include driving the car (actual use) and the availability of the car for his use to the exclusion of the company, such as when it is parked at home, or at a restaurant that Peter is visiting.

Although Peter may have general permission to use all five of the cars, he does not use all of them for the purposes of Division 7A. The four cars that Peter leaves at the company premises are available for the company to loan to another shareholder, employee, customer, or other party. That is, these cars are not available to Peter to the exclusion of the company.

5.12 The EM also includes examples of where an asset is available to more than one shareholder or associate and it is necessary to determine who is taxed. The EM suggests and apportionment of the taxable value to the person who is the real recipient of the benefit. One example sets out that a minor that benefits should not be taken to receive a Division 7A payment, where another sets out that incidental use by a spouse of a vehicle provided to a shareholder would not result in the spouse being taxed on the benefit provided.

5.13 In valuing the payment taken to be made it will be the amount that would have been paid for the use of the asset in an arm's length dealing less any consideration paid that will be determined to be the payment for Division 7A purposes.

5.14 There are a number of exceptions from the payment provisions applying, including one not previously announced dealing with residential property:

5.14.1 Minor benefits – if the provision of the asset would have been a minor benefit under section 58P of the FBTAA had it been provided to an employee then the benefit will be disregarded for Division 7A purposes

5.14.2 Otherwise deductible payments – if a once off deduction would have been available to the shareholder or their associate in connection with the use of the asset then there will be no benefit to be taken into account for Division 7A purposes.

5.14.3 Dwellings – the use of a dwelling can be exempt where the following conditions are satisfied:

5.14.3.1 the entity or their associate is carrying on a business;

5.14.3.2 the entity or their associate uses or is granted or has a lease, licence or other right to use land, water or a building for the purpose of carrying on the business; and

5.14.3.3 the provision of the dwelling to the entity is connected with that use or with that lease, licence or other right to use the land, water or building to carry on the business.

5.14.4 Main residences – the provision of a dwelling that is a person's main residence does not result in a Division 7A payment where:

5.14.4.1 The provider of the dwelling is a private company;

5.14.4.2 The private company acquired the dwelling before 1 July 2009; and

5.14.4.3 The private company would pass COT from the time that the dwelling was acquired until the end of the time that a payment could be taken to be made under Division 7A.

5.14.5 Vacant land – if the exception for a dwelling or a main residence applies, it will extend to adjacent land in the same way as occurs in the main residence exemption.

Corporate limited partnerships

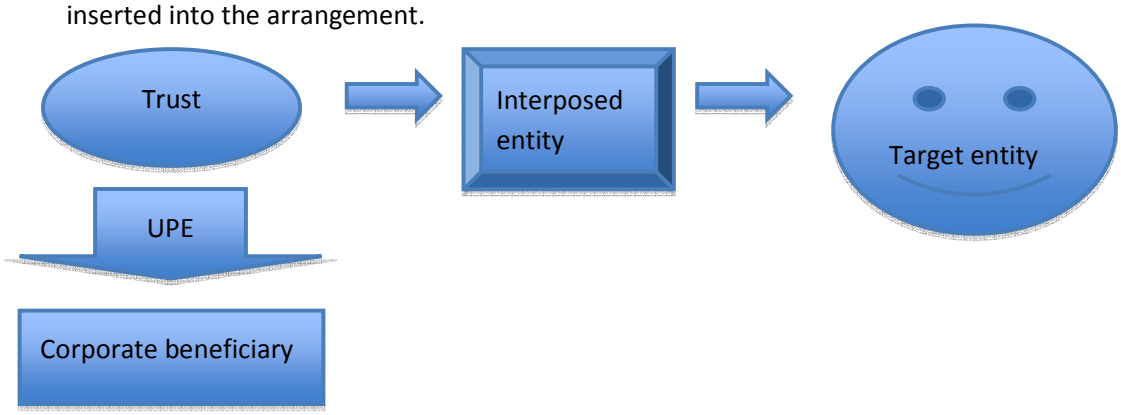
5.15 Closely held corporate limited partnerships (limited liability partnerships) will also now be subject to Division 7A. A corporate limited partnership will be closely held where it has fewer than 50 members or where an entity has, directly or indirectly, for the entity's own benefit, an entitlement to 75% or more of the income and capital of the partnership.

Interposed entities

5.16 The Div 7A Amendments fix two drafting issues in relation to the use of interposed entities.

5.17 The Division 7A legislation as originally drafted allowed for a payment by a private company through an interposed entity to be treated as a payment for Division 7A purposes.

5.18 The legislation did not however on a plain reading, allow for a trust where there was an unpaid present entitlement, to be deemed to have made a payment where an interposed entity was inserted into the arrangement.



5.19 A payment from the trust through an interposed entity to a target entity will now be caught by Division 7A if a reasonable person would consider that a loan or payment made to the interposed entity was made to enable a loan or payment to be made by the interposed entity to the target entity.

5.20 Consistent with the current operation of Subdivision EA however, a payment through to the target entity will only result in a Division 7A deemed dividend if it is referable to a reduction in a present entitlement that is in itself attributable to an unrealised gain in the trust.

5.21 The Div 7A Amendments also ensures that where an unpaid present entitlement is owed to a company by a trust, but the loan, payment or forgiveness that occurs does not involve the trust that owes the unpaid present entitlement, that Subdivision EA still has effect.

5.22 Subdivision EA will apply to treat a loan or payment from a trust as being a Division 7A loan or payment to the extent that the loan or payment is referable to an unpaid present entitlement owed to a private company where that amount has not already resulted in a Division 7A loan or payment.

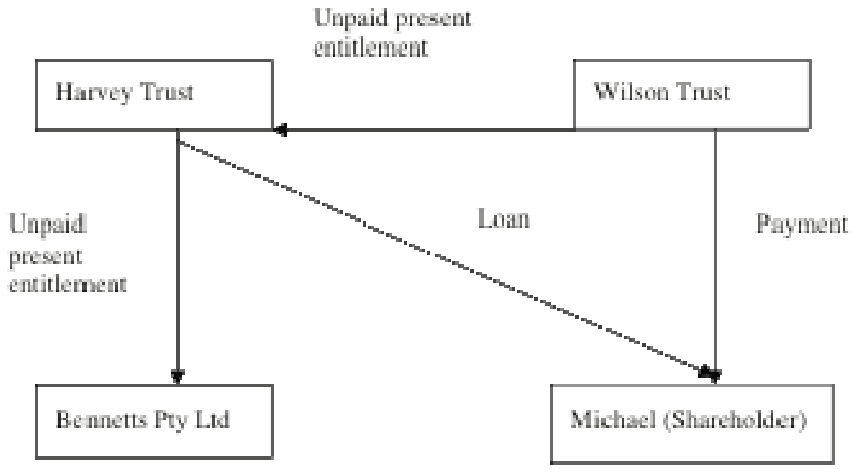
Example (interposed trust from EM)
Michael is a shareholder of Bennetts Pty Ltd and Bennetts Pty Ltd is a beneficiary of Harvey Trust. In the 2009-10 income year, Michael receives a payment from the trustee of the Wilson Trust, which is attributable to an unrealised gain. He receives this payment

because of his shareholding in Bennetts Pty Ltd. Michael also receives a $2,000 non-compliant Division 7A loan from the Harvey Trust.

Bennetts Pty Ltd is not presently entitled to an amount from the net income of the Wilson Trust. However, Bennetts Pty Ltd is entitled to $10,000 from the net income of the Harvey Trust (the first interposed trust) and Harvey Trust is presently entitled to $10,000 from the net income of the Wilson Trust. These amounts remain unpaid.

The loan made by the Harvey Trust to Michael will be included in Michael's assessable income under ordinary operation of subsection 109XA(2).

Bennetts Pty Ltd is taken to be presently entitled to $8,000 from the Wilson Trust, which is the unpaid present entitlement of $10,000 from the Harvey Trust, reduced by the $2,000 loan amount that is included in Michael's assessable income under another provision of Subdivision EA.



Loan back arrangements

5.23 Subdivision EA as currently drafted only captures payment arrangements where the payment is a reduction of a present entitlement that is referrable to an unrealised gain.

5.24 To circumvent these rules, apparently it had been suggested that the following arrangement could be entered into:

5.24.1 An unpaid present entitlement exists to a private company, say of $100,000.

5.24.2 A payment is made by the trustee of the trust to a beneficiary of an amount far in excess of the UPE, for example $1 million.

5.24.3 The amount in excess of the UPE is then loaned back to the trustee, being $900,000.

5.24.4 Thus, the beneficiary now has a credit loan of $900,000.

5.24.5 In future years the trustee appoints income to the company and uses the funds to repay the credit loan.

5.25 The need for there to be a payment referrable to a reduction of an unrealised gain will be removed where the payment made to a beneficiary is in reduction of a loan made on or after 1 July 2009 where a reasonable person would conclude that the trustee obtained the loan in order to make the payment.

Amendment to distributable surplus definition

5.26 The definition of distributable surplus will be amended so that amounts that have been deemed to be dividends as a result of the operation of Subdivision EA will be removed from the distributable surplus (by being correctly included as non-commercial loans).

Forgiveness of 109XB loans

5.27 There is a drafting problem that will be rectified so that the forgiveness of a loan by a trustee that has already been deemed to be a dividend will not result in a subsequent dividend. The law already applies in this way to the forgiveness of a debt owed to a private company by a shareholder that has already been deemed to receive a dividend under Division 7A.

Dividend set-off

5.28 Another drafting problem dealing with dividend set-offs will also be rectified.

5.29 At present, where a private company makes a loan that is deemed to be a dividend and later pays an unfranked dividend that is set off against that loan the later dividend is not included in assessable income.

5.30 The ability to disregard the later dividend does not apply where the loan was made by the trustee of a trust and where the deemed dividend arose under section 109XB.

5.31 The ability to disregard a later unfranked dividend offset against a loan from a trustee is being introduced.

Setting off employment entitlements

5.32 Another unusual aspect of the interaction of Division 7A generally and Subdivision EA has been that employment related payments that are offset against loans by trustees do not count as repayments if there is a borrowing of a similar or greater amount to the amount repaid. This is in contrast to setting off such a payment against a loan by a company where the repayment is taken into account even if there is a further borrowing.

5.33 This anomaly is to be rectified.

Borrowing to repay

5.34 Under the previous law a repayment is disregarded where the repayment is made where a reasonable person would conclude the repayment was made in order to borrow a similar or greater amount. This prevents a person from borrowing funds during a financial year, repaying on 30 June, and then reborrowing the amount on 1 July.

5.35 While the law has operated in this way (with some exceptions for repayments that occur by way of offsetting assessable amounts such as the wages noted above) it arguably has not operated where, instead of repaying to borrow, a person borrows to repay. This was be remedied so that a borrowing to repay will also activate section 109R.

> ***Example (from EM)***
> ***Alicia obtains a loan of $10,000 from Cleary Pty Ltd. Alicia has until the lodgment day to repay the loan. Two weeks before the lodgment day Alicia obtains a further $10,000 from Cleary Pty Ltd. She then repays the original $10,000 loan a week before the lodgment day.***
>
> ***The repayment of the original $10,000 loan is not a repayment for the purposes of section 109D, because Alicia has borrowed a similar amount from Cleary Pty Ltd and in this case a reasonable person would conclude that the loan was obtained in order to make the repayment of the original $10,000.***
>
> ***The original $10,000 loan is treated as a deemed dividend subject to the distributable surplus of the private company.***

Adding back payments for Division 7A purposes

6. Streaming

6.1 The paper will no consider the importance of, and ability to, stream as it stood before the Streaming Amendments. Then it will consider the Streaming Amendments.

Pre-Streaming Amendments

6.2 As can be seen from the illustrations above the ability to stream income according to its character is very important. This is particularly the case for franked dividends and capital gains but there are other forms of income with tax characteristics that may also be important e.g. income from a foreign source, income which has been subject to TFN withholding tax.

6.3 The decisions in Bamford tell us nothing about streaming income for tax purposes.

6.4 Most modern trust deeds will give the trustee power to distinguish between classes of income and to characterise a particular amount of income as having been derived from a particular source. The Deed should also allow the trustee to allocate expenses to the different classes of income.

6.5 The law regarding streaming after the decision in *CPT Custodian Pty Ltd v Commissioner of State Revenue [2005] HCA 53* ("**CPT Custodian**") was quite uncertain. The decision of the High Court in *Charles v C of T [1954] HCA 16* ("**Charles**") has always been the centre of gravity of the character flow through approach. The decision in Charles was heavily criticised by the Court in CPT Custodian. The question is whether that criticism went to the maintenance of character or is restricted to the characterisation of the interest in the trust fund by looking through to the underlying assets.

6.6 The decision of the High Court in CPT Custodian, in the writers' views, stands for the proposition that a beneficiary has an equitable interest in the residue of the trust fund after the Trustee's indemnity has been satisfied. This residue is characterless, whether it be income or capital, as the trustee may at any time satisfy its right to be indemnified from the receipts (which themselves have character).

6.7 Notwithstanding these problems the ATO has consistently taken the view that the character of the income in the hands of the beneficiary is taken from the character of the receipts of the Trustee[4] even after taking into account the decision in *CPT Custodian*[5].

6.8 In the non-binding ruling IT2328 (now withdrawn) it was observed:

> *"For income tax purposes where a beneficiary in a trust estate is presently entitled to the net income or a share of the net income of the trust estate, that income as a general principle has the same character in the hands of the beneficiary as it had in the hands of the trustee."*

6.9 The most significant streaming issues concern capital gains and dividends. In the case of capital gains Division 115 of Part 3-1 of the 1997 Act proceeds on an implication that income entitlements will take on at least some part of the character of the capital gains derived by the trustee. There is no clear legislative follow through. The guidance found in Sesction 115-200 of the 1997 Act establishes the implied maintenance of character:

> *"This Subdivision sets out rules for dealing with the net income of a trust that has a net capital gain. The rules treat parts of the net income attributable to the trust's net capital gain as capital gains made by the beneficiary entitled to those parts."*

[4] see in particular ATO ID 2008/51 dealing with Division 13.3A of the SIS Regulations.

[5] see Taxation Ruling STR 92/13, IT2328, IT2512, IT2004 (withdrawn) and ATO ID 2007/108 (which is concerned with foreign sourced income and in respect of which subsection 6B(2A) of the 1936 Act also comes into consideration).

6.10 Subsection 115-215(1) is the nub of the provisions:

> *"The purpose of this section is to ensure that appropriate amounts of the trust estate's net income attributable to the trust estate's capital gains are treated as a beneficiary's capital gains when assessing the beneficiary, so:*
>
> *(a) the beneficiary can apply capital losses against gains; and*
>
> *(b) the beneficiary can apply the appropriate discount percentage (if any) to gains."*

6.11 The process is described as attribution rather than maintenance of source character. This may be the necessary distinction to make the rules work. There is, however, no guidance about how the attribution is to be carried out.

6.12 What is clear is that if there is no trust income to which the beneficiary is presently entitled there can be no attribution. This is a major issue where there is no trading income but there are capital gains in the Trust. Use of s 95(1) terms to describe income overcomes this problem and makes the case for attribution much clearer. The capital gain (or at least 50% of it) will be included in the income. The connection for Subdivision 115-C purposes is very clear.

6.13 The ATO has had to resort to the artificiality of the "capital beneficiary approach" in PS LA 2005/1 (GA) to achieve this sensible outcome – but this practice statement was withdrawn following Bamford.

6.14 The issues with streaming can be readily appreciated in the context of capital gains and the 50% general CGT discount. The streaming issue is, of course, the denial of the 50% CGT general discount when a trust to company distribution is in play.

6.15 Maintaining the example used above in which there is a net capital gain of $100,000, and gross rental income of $50,0000 and net rental income of $20,000.

6.16 In this instance the trustee wishes to cause the capital gain to be assessed in the hands of an individual (say Mrs A) and the net rental income in the hands of a company, A Co. If it is assumed that the Trust Deed has all of the usual income characterisation and streaming provisions and the Deed adopts subsection 95(1) terms, the outcome readily appears.

6.17 The income entitlements are:

	$	
A Co	20,000	comprising net rental income
Mrs A	50,000	comprising the capital gain
	70,000	

6.18 If the ATO took the view that streaming was unobtainable the outcome would be:

	$	$ Total
A Co	5,714 + taxable capital gain $28,572	34,286
Mrs A	50,000	50,000
		84,286

6.19 The other area of concern is franking credits. At least there is a ruling on this aspect of streaming, *Taxation Ruling* 92/13 (repealed as of 22 June 2011 because of the Streaming Amendments). The provisions of Subdivision 207-B and in particular ss 207-45 to 207-57 are consistent with flow through of the franked character of a dividend.

6.20 The fact the Example set out immediately below s 207-35(3) of the 1997 Act depends on character maintenance. It is worthwhile setting this Example out in full:

> *"A franked distribution of $70 is made to the trustee of a trust in an income year. The trust also has $100 of assessable income from other sources. Under subsection (1) the trust's assessable income includes an additional amount of $30 (which is the franking credit on the distribution). The trust has a net income of $200 for that income year.*
>
> *There are 2 beneficiaries of the trust, P and Q, who are presently entitled to the trust's income. Under the trust deed, P is entitled to all of the franked distribution and Q is entitled to all other income.*
>
> *The distribution flows indirectly to P (as P is entitled to a share of that net income and has a 100% share of the distribution under section 207-55). P therefore has an amount of assessable income that is equal to its share of the distribution. Under this subsection, P's assessable income also includes the full amount of the franking credit (as P's share of the franking credit on the distribution is $30 under section 207-57). Q's share of the net income therefore does not include any of the franking credit."*

6.21 Clearly the legislation contemplates maintenance of character for the purposes of dividend imputation.

Commissioner's Concern of Division 6 Abuses

6.22 As usual the ATO is driven by the possibility that the decision in Bamford might support some abuse and revenue loss. No matter that their interpretations lead to massive headaches for practitioners.

6.23 This much is exampled by several examples set out *in Practice Statement PS LA 2009/7* which was released prior to the decision in Bamford.

6.24 Examples 1 and 5 in particular show what the ATO is on about.

6.25 Example 1 concerns the trustee of a family trust deriving $250,000 in income during the income year and applying that income to the purchase of a holiday home. The trustee, acting in accordance with a power expressed in the terms of the Trust Deed to do so, determines that the expenditure on the purchase of the house is an outgoing on income account with the effect that the trust law income available for distribution is $5,000. One of the beneficiaries has tax losses.

6.26 The trustee distributes the $5,000 trust law income to the loss beneficiary. The losses cover the tax law income which follows the trust law income to the loss beneficiary.

6.27 The ATO expresses concern about the mismatch of the actual amount to which the beneficiary becomes entitled ($5,000) and the amount of the tax law income flowing to the beneficiary ($250,000) and the tax not paid because of the losses.

6.28 It is difficult to say why this is of concern to them. The true effect of the transaction is to maintain $245,000 in the capital of the trust. The same tax effect would be obtained by distributing all of the $250,000 to the loss beneficiary. There is no tax difference in this illustration. It is unlikely there would be a tax benefit for the purposes of Part IVA. The most likely explanation for the transaction is the financial risk the loss beneficiary has been exposed to. If the beneficiary became entitled to call on the trustee to pay him or her $250,000 the creditors may be able to stake a claim to that amount. It is a neat and sensible piece of asset protection planning.

6.29 Example 5 is about a trust which has distinct income and capital beneficiaries. The trustee has a power to determine whether receipts and outgoings are on income or capital account. The Trust Deed is amended to admit a tax exempt entity as a beneficiary.

6.30 The trust derives $100,000 of income (meaning income according to ordinary concepts) during the income year. The trustee determines that $95,000 of that amount is a capital receipt. The remaining $5,000 is the trust law income according to the Trust Deed. This amount is appointed to the tax exempt beneficiary. All of the tax law income will be assessed to the charity. It would follow that the trustee makes a capital distribution of the $95,000 to a family beneficiary.

6.31 The ATO observe in the Practice Statement that Part IVA might apply in the circumstances. In the writer's view it almost certainly would do so in particular because of the amendment to introduce the tax exempt charity as a beneficiary and the fact that prior year distributions had been made only to family members. A much more challenging (and perhaps more realistic) illustration would arise if the tax exempt charity was already an object and the trustee had made distributions to charities in the past. The Part IVA case in such circumstances would be difficult to make out. This is an example of the acknowledged "apparent unfairness in the resulting administration of the legislation" as noted by the High Court in Bamford at [17].

6.32 The ATO apparently accept that Bamford authorizes characterization of capital receipts as income for the purposes of the Deed but are not so ready to accept that ordinary income may be recharacterised as capital (as in Example 5). They appear to be fortified in this by observations made by the Full Court of the Federal Court in *Forrest v C of T* [2010] FCAFC 6 ("**Forrest**").

6.33 The relevant question before the Court there was whether Mr Forrest was entitled to a deduction for interest he had incurred in relation to funds he had borrowed to acquire units in a unit trust. The outcome turned on whether there was a fixed income component to which the funds related. The Full Court concluded that a power to determine whether any amount received by the trustee was on revenue account or capital account (clause 12 of the Deed) was not a power to change the beneficiaries' rights. In so doing they observed at [11]-[12]:

> *'In our opinion, the power conferred by cl. 12 cannot be exercised by the trustee wrongly to classify a receipt as a capital gain, when the receipt is, in truth, income, and thus deprive the appellant of his interest in the unit component of the trust. Clause 12 is not an unlimited power to be exercised in the trustee's unconfined discretion….*
>
> *Clause 12.2(a) is a power to determine how a distribution to beneficiaries is classified. That limited power is not a power which is capable of altering the beneficiaries' rights. Clause 12 is to be read consistently with the balance of the Trust Deed and an appreciation that it contains various powers of an administrative character. The words used can be given full force honestly to classify income or distributions according to law, as the appellant contended to this Court".*

6.34 It is very difficult to know how far this goes. The issue in Forrest was about whether or not the exercise of the power changed the rights as between classes of beneficiaries. Presumably the ATO would say that the exercise of the power in a case like that in Example 5 was not an "honest" classification of the receipt as capital. Hopefully the issue will not arise very often.

Point of Interest

6.35 A case of interest is *Greenhatch v FCT* [2011] AATA 479 that ostensibly concerned superannuation contributions where the answer to the superannuation question was determined by construing streaming through a trust. The case of is interest for two reasons.

6.36 First, the AAT went out of their way to note the Commissioner's interpretation of Bamford was wrong. At [49] and [50] they said:

> *Much, if not all, of the Commissioner's case turns on his rejection of any underlying conduit theory and his interpretation of the implications of the decision in Bamford.*

The Commissioner's contention that the conduit theory has no role to play is based on foundations with which we do not agree. Accordingly, those foundations do not support the conclusion he seeks to draw.

6.37 Secondly, in relation to Subdivision 207-B of the 1997 Act, being the franking credits provisions, the AAT observed at [63]:

> *Section 207-35 of the 1997 Act has an aspect that makes the conclusion [that] amounts passing through trusts to beneficiaries thereof carry the character and identity that they had in the hands of the trustee more compelling. That section includes an example that contemplates differential distributions in determining the taxation burdens that are imposed on the beneficiaries of the trust.*

6.38 Question: was it necessary to introduce the Streaming Amendments in light of the above comments? Given we have the Streaming Amendments it is of academic interest only.

Streaming Amendments

6.39 The *Tax Laws Amendment (2011 Measures No. 5) Act* 2011 (Cth) was introduced into parliament (as a Bill) on 2 June 2011, was passed unamended and assented to on 29 June 2011. They take effect from 1 July 2010. These dates show how close a call it was as the Streaming Amendments are critical for trustee decisions that were needed to be made on 30 June 2011 – one day after their royal assent.

6.40 Subject to a statement by the Commissioner – extending the time a trustee could make decisions to 31 August 2011, which has anyway passed, but the writers question the Commissioner's ability to alter what trust law[6] requires to be done on 30 June of any year – the Streaming Amendments apply to trustees resolving to deal with trust income and capital gains.

6.41 From the 2011 income year and thereafter taxable capital gains and franked distributions are dealt with under these rules.

6.42 The Streaming Amendments operate by diverting from Division 6 of the 1936 Act the franked distributions and taxable capital gains. They are assessed directly in the hands of the beneficiaries who are presently entitled to them. They do this via Subdivision 207-B of the 1997 Act for franked distributions and via Subdivision 115-C of the 1997 Act for taxable capital gains. However, for the taxable capital gains they must still pass through the method statement in s 102-5(1) of the 1997 Act.

[6] *Trustees of the Estate Mortgage Fighting Fund Trust v FCT* [2000] FCA 981 per Hill J; *Case R105,* 84 ATC 692; *Antonopoulos v FCT* [2011] AATA 431.

6.43 The Streaming Amendments have introduced a new Division 6E into Part III of the 1936 Act to prevent double taxation. It adjusts the Division 6 income and net income of the trust to take out the amounts to which the beneficiary has been made specifically entitled.

6.44 It can be seen that the specific entitlement of the beneficiary or beneficiaries is the critical aspect of the Streaming Amendments. This is required to determine tax liability.

Specific Entitlement

6.45 The notion of a specific entitlement conceals the difficulties of applying the Streaming Amendments to all trusts, be they discretionary, fixed, unit, et cetera. The mechanism by which you become specifically entitled are set out in the relevant Subdivisions: s 115-228 for capital gains and s 207-58 for franked distributions. The provisions seem substantially similar at first look but there are some significant differences.

6.46 A beneficiary is specifically entitled under s 207-58 of the 1997 Act to an amount of a franked distribution made by the trust equal to the amount calculated under the following formula

$$\text{Franked Distribution} \times \frac{\text{Share of net financial benefit}}{\text{Net financial benefit}}$$

6.47 The "net financial benefit" is an amount equal to the financial benefit referable to the franked distribution (after an application by the trustee of expenses that are directly relevant to the franked distribution).

6.48 The term "financial benefit" is already in s 995-1 f the 1997 Act. It means anything of economic value, even if the transaction also imposes an obligation on the entity. Benefits and obligations are to be looked at separately and not set off against each other, but it is the net financial benefit to which the formula looks.

6.49 The "share of the financial benefit" is the amount of the financial benefit referable to the franked distribution specifically linked to the particular beneficiary. The share of the net financial benefit is:

> *… an amount equal to the *financial benefit that, in accordance with the terms of the trust:*
>
> *a. the beneficiary has received, or can be reasonably expected to receive, and*
>
> *b. is referable to the *franked distribution (after application by the trustee of any expenses that are directly relevant to the franked distribution) and*
>
> *c. is recorded, in its character as referable to the franked distribution, in the accounts or records of the trust no later than the end of the income year.*

6.50 Section 115-228 is identical to the discussion above of franked distributions, subject to:

6.50.1 the financial benefit must be referable to the capital gain "after application by the trustee of any losses, to the extent that the application is consistent with the application of capital losses against the capital gain in accordance with the method statement in subsection 102-5(1)"; and

6.50.2 the recording of the financial benefit must be "no later than 2 months after the end of the income year."

Complexities and Going Forward

6.51 An issue to be mindful of is – in fact an issue of significant importance – is that a trust with no "income", which was one of the problems in the Bamford appeals, will not be able to stream franking credits. This will mean that where the franked distributions, together with other ordinary income, is insufficient to more than offset expenses of the trust the franking credits cannot go through to the beneficiaries. The same restriction does not apply in relation to capital gains streamed through the trust.

6.52 Ken Schurgott FTIA, in his paper in the August 2011 *Taxation in Australia* titled "Trust streaming 2011" notes a number of complications that arise from the Streaming Amendments:

> *As will be seen, there are a number of issues which emerge that complicate the legislation over and beyond the rather simple approach adopted prior to the Commissioner's stance on streaming. The things which complicate matters are:*
>
> *a. There can be different outcomes according to the definition of income adopted by the trust deed;*
>
> *b. Significantly different outcomes can result where a beneficiary has not been made specifically entitled to the franked distribution or capital gain. This is most pronounced in relation to capital gains;*
>
> *c. The concept of making a beneficiary entitled to the entire financial benefit from a capital gain or franked distribution is fraught with difficulty, particularly where there are capital losses or directly related expenses; and*
>
> *d. The way in which capital losses and directly related expenses are to be dealt with is confusing.*

6.53 It can be seen from these further issues, and the problem of actually apply what is a simple concept of diverting the amounts to Subdivisions 115-C and 207-B respectively, are anything but straightforward or settled. Indeed, a senior council on the writer's floor, after having advised on

the Streaming Amendments is of the view that this is where future archeologists will find the bones of 21st Century tax lawyers and accountants.

7. Changes to the taxation of trusts – terms to be provided for in a trust document

7.1 Given the changes in the taxation of trusts, it is recommended that trust deed (or any other constituent documents) be reviewed so as to determine:

7.1.1 How income, capital gains and outgoings are accounted for and determined; and

7.1.2 How income, capital gains and outgoings are to be distributed.

7.2 Some of the powers which may be advantageous to have within a trust instrument include:

7.2.1 an accounting policy which is sufficiently broad and allows the trustee to exercise maximum discretion;

7.2.2 the discretion to reclassify and allocate income and capital gains;

7.2.3 the discretion to reclassify and allocate outgoings;

7.2.4 the discretion not to recoup losses (whether income or capital in nature);

7.2.5 the ability to allocate and stream classes of income and capital and their related tax attributes;

7.2.6 and ensure that any unpaid present entitlement / loan provisions are removed, and an ability to hold amounts subject to a sub-trust.

7.3 Some additional powers to be considered include:

7.3.1 whether the trustee has the power to distribute income and / or capital at any time within a tax year;

7.3.2 whether any determination of income (or capital) can be made within the income tax year; and

7.3.3 whether the trustee has a power to determine entitlements with respect to an income tax year after the relevant year.

Accounting policy

7.4 Essential is ensuring that the trust deed provides guidance with respect to an accounting policy that should be used by the trustee. Such an accounting policy should provide sufficient flexibility for the trustee, so that it may depart from generally accepted accounting standards in the event that the trustee considers that it is appropriate to do so.

Reclassifying and allocating income and capital

7.5 As the High Court in *Bamford* accepted that the tax law income of a trust is dependent upon (amongst other things) the definition of that term in the trust deed, regard should be given to the definition of the 'income' as contained in the trusts constituent documents.

7.6 An issue to consider is whether attributed amounts (e.g. franking credits) should be included within the definition of trust income. An issue that arises is that if attributions are included in trust income (and which are not physically 'paid' by a trustee – but which follow certain amounts of income), whether by being included in trust income, and thereby providing that a trustee creates a 'present entitlement' in a beneficiary to an amount that is never received by a trustee, the trustee will be exposed to a claim in relation to amounts that are not actually received by the trustee.

7.7 It is submitted that amounts such as franking credits should be prima facie carved-out of the definition of income. However, the definition should contain discretionary elements to allow a trustee to cause such 'attributed' amounts to fall within the definition of income.

7.8 An approach which may be considered is, in defining trust income:

7.8.1 Provide that it prima facie equals the amount provided for in s 95(1) of the 1936 Act (less any franking credits);

7.8.2 If the tax law approach is not warranted for a particular tax period, then:

7.8.2.1 According to an accounting policy adopted by the trustee; or

7.8.2.2 Any other basis as determined by the trustee; or

7.8.3 In the trustee's absolute discretion, the gross income of the trust.

Reclassifying and allocating outgoings

7.9 In *Cajkusic v FC of T (No 2)* (2006) ATC 4752 ("**Cajkusic**") deductions allowable to a family discretionary trust for payments that were made under an employee benefits trust arrangement in the income tax years ending 30 June 1997 and 30 June 2008 caused there to be a loss within the trust estate.

7.10 As a result of the losses, there was no distributable income of the trust. As a result, the Full Court of the Federal Court held that the lack of distributable income meant that there could be no beneficiary of the trust (for the relevant income tax years) to be "*… presently entitled …*'"pursuant to s 97 of the 1936 Act to any amount.

7.11 It should be noted that the Commissioner's subsequent application for special leave to appeal to the High Court was rejected.

7.12 Cajkusic stands for the proposition that the 'distributable income' of a trust is determined by reference to proper accounting principles, as well as the terms of a trust deed. In this context distributable income is income determined according to accounting principles, and which is distributable amongst the beneficiaries. It does not alter either the income as calculated under accounting principles, of the 'net income' as determined under s 95(1) of the 1936 Act – rather, only gives a trustee the power to determine the distributable amounts.

7.13 As a result of the decision in Cajkusic, it is submitted that a trust deed should give a trustee the power to reclassify, and allocate outgoings, so that there can be 'distributable income' to which beneficiaries are presently entitled.

Discretion not to recoup losses (whether income or capital in nature)

7.14 It is recommended that a trustee have a discretion not to recoup losses (whether of an income or capital nature). That is, a power not to recoup losses which have arisen in the past.

8. Resettlement considerations

8.1 Whenever the terms of a trust are varied, an issue to consider is whether the variation amounts to a 'resettlement'.

8.2 Resettlements relate to changes to a trust relationship which have the effect that a new trust estate comes into existence. According to the High Court in *FC of T v Commercial Nominees of Australia Ltd* [2001] HCA 33 (***"*Commercial Nominees"**), the issue to determine is whether '*… what occurred* … [i.e. the variation] … *was a fundamental alteration in the trust relationship*

established by the original deed, such that it destroyed the necessary continuity of the 'taxpayer'…'.

8.3 A resettlement can have significant income tax, capital gains tax (**'CGT'**) and stamp duty consequences, including that:

8.3.1 the trust property may be disposed of, potentially triggering both stamp duty and CGT liabilities;

8.3.2 carried forward tax benefits may be lost; and

8.3.3 beneficiaries may dispose of their interests in the original trust and acquire interest in a new trust.

8.4 Specifically in the context of CGT, a resettlement may cause either CGT event E1 (s 104-60 of the 1997 Act) or CGT event E2 (s 104-65 of the 1997 Act) to happen.

8.5 In August 2001 the issued a Statement of Principles entitled *Creation of a new trust* (the **"Statement**"). The Statement clarifies when, in the Commissioner's view, changes to a trust gives rise to a new trust. The Commissioner considers that a new trust estate arises where there is a 'fundamental change to a trust relationship' – ie, a change in the essential nature and character of the original trust relationship. Further, the Commissioner considers that a new trust (i.e. a resettlement) may arise in the following circumstances:

- a change in beneficial interest in trust property;
- a new class of beneficial interest (whether introduced or altered);
- a redefinition of the beneficiary class;
- changes in the terms of the trust or the rights or obligations of the trustee;
- changes in the nature of the trust property;
- additions of property which could amount to a new and separate settlement;
- depletion of trust property;
- a change in the termination date of the trust;
- a change in the trust that is not contemplated by the terms of the original trust;

- a change in the essential nature and purpose of the trust; and / or
- a merger of two or more trusts or a splitting of the trust.

8.6 The Commissioner considers that depending on their nature and extent, the above changes may either amount to:

8.6.1 a variation of a continuing trust; or

8.6.2 a fundamental change in the essential nature and character of the trust relationship. In such a case, the original trust may be brought to an end and a new trust created. Whether a new trust is created depends on the terms of the original trust and on the powers of the trustee.

8.7 The High Court in Commercial Nominees held that significant changes to a superannuation fund trust deed did not create a new trust, even though the amending deed had:

8.7.1 changed the name of, and appointed a new trustee to the fund;

8.7.2 introduced a new category of beneficiaries;

8.7.3 changed the fund from a defined benefit fund to an accumulation fund;

8.7.4 appointed a professional management company as administrator; and

8.7.5 allowed membership to be promoted to the public.

8.8 The High Court in *Commercial Nominees* considered that there were three main indicators of the continuity of a trust relationship, being:

8.8.1 the constitution of the trust;

8.8.2 the trust property; and

8.8.3 the membership of the trust.

8.9 Substantial changes any of the above may cause a resettlement.

8.10 The High Court considered that, in order to destroy the necessary continuity, changes in one or more of the above indicators must be such as to terminate the existence of the entity, or to produce the result that the particular trust does not derive the income in question. It was held that the changes made to the trust deed in question were not sufficient to destroy the continuity, primarily because the fund was at all times governed by the same deed, the trust property did not change, and the members before the amendment to the trust deed remained members afterwards. We consider that the amendments discussed above will not cause a resettlement.

8.11 The Commissioner notes in the Statement that administrative changes, such as re-defining trust income (without more) may not cause a resettlement (depending on the context) as it may be administrative in nature.

8.12 However, regard will need to be given to the implications to the membership (i.e. the beneficial entitlements) of the trust, and what implications such an amendment will have on the respective entitlements in a trust. For example, an important consideration will be determining how unallocated / undistributed income is to be dealt with. For example, is such income:

8.12.1 accumulated, and form part of the corpus of the relevant trust estate;

8.12.2 is it distributed to certain default beneficiaries; or

8.12.3 is it held on trust for a specific purpose (e.g. a charitable purpose).

Changes in the Taxation of Trusts

A paper presented by Michael Bennett and Denis Barlin at the NSW Young Lawyers CLE

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Michael Bennett E bennett@sevenwentworth.com.au D 8224 3055 M 0408 029 416
Denis Barlin E dbarlin@wenworthchambers.com.au D 9231 6646 M 0404 848 311

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1. General overview

1.1 The income years ended 30 June 2010 and, more particularly, 30 June 2011 have been very active for the taxation of trusts. Significant events in three areas of trust taxplay activity:

1.1.1 decisions of the Courts and principally the High Court's decision in *Commissioner of Taxation v Bamford* (2010) 240 CLR 481; (2010) 264 ALR 436; [2010] HCA 10 ("**Bamford**");

1.1.2 legislative changes, principally:

1.1.2.1 the new rules set out in *Tax Laws Amendment (2011 Measures No. 5) Act* 2011 (Cth) (the "**Streaming Amendments**") that deal with taxation of franking credits and capital gains in trusts; and

1.1.2.2 the new rules set out in the *Tax Laws Amendment (2010 Measures No. 2) Act* 2010 (Cth) that are principally about Division 7A of Part III of the *Income Tax Assessment Act* 1936 (Cth) (the "**1936 Act**") and companies providing rights to use property, but also contain some trust issues (the "**Div 7A Amendments**"); and

1.1.3 Australian Taxation Office ("**ATO**") activities principally the very controversial draft ruling on unpaid present entitlements, TR 2009/D8.

1.2 Some of these changes have overtaken themselves. For instance, there was at the time – and this paper includes – a discussion of streaming post Bamford (see **heading 4** below). That discussion should be read as having been overtaken by the Streaming Amendments (see **heading 5**).

1.3 And what's more the change is not over. Chapter 2 of the explanatory memorandum to the Bill that introduced the Steaming Amendments makes it clear that the streaming provisions have been introduced as an interim measure to deal with perceived anomalies in the taxation of capital gains and franked distributions pending a comprehensive review of Division 6 of Part II of the 1936 Act.

1.4 The changes made so far give rise to issues themselves and further consequential issues for trusts. In addressing the issues – both outlined above and the consequential issues – this paper will discuss:

1.4.1 Taxation of trusts generally;

1.4.2 The competing views before Bamford;

1.4.3 The context of Bamford and what it means for trusts;

1.4.4 Briefly (as it is not germane to the other issues raised in the paper) what are the Div 7A Amendments and what they mean for trusts;

1.4.5 What are the Steaming Amendments and what they mean for trust;

1.4.6 What a trust deed needs in light of those three issues; and

1.4.7 Amending trust deeds to deal with those three issues.

1.5 The issues are dealt with in this order as they are chronological to their occurring.

2. Taxation of Trusts

2.1 The provisions dealing with the taxation of trust income are contained in Division 6 of Part III of the 1936 Act (which comprises of sections 95 to 102).

2.2 As a result of the enactment of Streaming Amendments, regard should also be given to:

2.2.1 Subdivision 207-B of the *Income Tax Assessment Act* 1997 (Cth) (the "**1997 Act**") – which deals with franking credits obtained by a trust estate; and

2.2.2 Subdivision 115-C of the 1997 Act – which deals with the distribution of capital gains by a trust estate.

2.3 Chief Justice Latham in *Tindal v FC of T* (1946) 72 CLR 608 at 618 observed that the object of Division 6 of the 1936 Act is to "*… secure payment of tax upon the whole of the net income of a trust estate, either from a beneficiary or the trustee, whether the income is paid over to or on account of the beneficiary …*". Further, according to Emmett J in *Bamford v Federal Commissioner of Taxation* (2009) 176 FCR 250 "*… an important assumption underlying Division 6 …* [is] *… that a beneficiary who derives a share of the net income should be in a position to pay out of that income; otherwise, the beneficiary could be placed in a difficult position*."

2.4 The starting point in determining the taxation of trust income is s 97 of the 1936 Act. Relevantly, s 97(1) of the 1936 Act 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; and

(b) the exempt income of the beneficiary shall include:

(i) so much of the individual interest of the beneficiary in the exempt income of the trust estate as is attributable to a period when the beneficiary was a resident; and

(ii) so much of the individual interest of the beneficiary in the exempt 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;

except to the extent to which the exempt income to which that individual interest relates was taken into account in calculating the net income of the trust estate; and

(c) the non-assessable non-exempt income of the beneficiary shall include:

(i) so much of the individual interest of the beneficiary in the non-assessable non-exempt income of the trust estate as is attributable to a period when the beneficiary was a resident; and

(ii) so much of the individual interest of the beneficiary in the non-assessable non-exempt 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]

2.5 That is, s 97 of the 1936 Act provides that where a beneficiary, who is not under a legal disability is presently entitled to a "*… share of the income of the trust estate …*", the assessable income of:

2.5.1 a resident beneficiary includes the beneficiary's share of the '*… net income of the trust estate …*'; and

2.5.2 a non-resident beneficiary includes so much of the beneficiary's share of the net income of the trust as is attributable to sources in Australia.

2.6 It should be noted that the term "net income of the trust estate" for the purposes of s 97 of the 1936 Act is defined in s 95(1) of the 1936 Act. However, the term "*… the income of the trust estate …*" as contained in s 97 of the 1936 Act is not defined in the 1936 Act.

2.7 Subsection 95(1) of the 1936 Act defines the term 'net income', in relation to a trust estate as:

> ***net income**, 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 Division 393 of the Income Tax Assessment Act 1997 (Farm management deposits) 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.*

2.8 For completeness, it should be noted that:

2.8.1 s 98 of the 1936 Act provides that the trustee is liable to tax on behalf of a beneficiary where the beneficiary is presently entitled to a share of the income of a trust estate, but the beneficiary is under a legal disability;

2.8.2 ss 99 and 99A of the 1936 Act apply to subject the trustee to tax where there is some part of the net income of a trust estate that is not subject to tax under either of ss 97 or 98 of the 1936 Act. The difference as between s 99 and s 99A of the 1936 Act is the rate of tax applicable. Typically, the trustee will be subject to tax under section 99A of the 1936 Act at a penal rate of tax equal to the maximum rate of tax (currently 45%). However, the Commissioner has a discretion to apply s 99 of the 1936 Act in certain circumstances, in which case the trustee will be subject to tax at the normal marginal rates of tax.

3. The two competing views before the decision in Bamford

3.1 There has been, for some time, two competing views in the taxation of trust income – the proportionate view and the quantum view.

Proportionate approach

3.2 *David & Anor v FC of T* 89 ATC 4377 contains an example of the application of the proportionate approach (which according to the High Court's decision in Bamford, is the correct approach).

3.3 The proportionate view looks to the share (or proportion) of trust law income of a trust to which a beneficiary is "presently entitled", and then applies that share or proportion to the net income of a trust estate to calculate how much of the net income is to be included in the beneficiary's assessable income.

3.4 As an example, if a beneficiary is entitled to one half of the trust law income, then the beneficiary must include half of the net income in their assessable income – irrespective of whether it is more or less than the amount of the trust law income to which they are entitled.

(a) Implications if tax law income exceeds trust law income

3.5 Under this approach, a beneficiary who is "presently entitled" to trust law income may be required under s 97(1) of the 1936 Act to include in their assessable income an amount of net income which is greater than the amount of trust law income to which they are entitled, and to which has been paid or distributed to them.

3.6 That is, they may be subject to tax on amounts whish they will not receive, and are not entitled to actually receive.

3.7 This outcome seems to be contrary to the objectives of Division 6 of the 1936 Act as outlined by Emmett J in the Full Court of the Federal Court decision in *Bamford v Federal Commissioner of Taxation* (2009) 176 FCR 250 (discussed above).

(b) Implications if trust law income exceeds tax law income

3.8 However, where the net income of a trust estate for the purposes of s 95(1) of the 1936 Act is less than the trust law income, then a beneficiary who is "presently entitled" pursuant to s 97(1) of the 1936 Act will be required to include in their assessable income an amount which is less than the trust law income to which they will be entitled, and which will be paid to them.

3.9 As a result, an on the assumption that the beneficiaries are "presently entitled" to the whole of the trust law income, with the result that the whole of the "net income" of the

trust estate is included in their assessable income pursuant to s 97(1) of the 1936 Act, there can be no part of the net income to which ss 99 or 99A of the 1936 Act applies.

3.10 There is still a question as to whether, in these circumstances, the beneficiary must include the excess amount (i.e. the amount not included under s 97(1) of the 1936 Act) under some provision of the tax acts (e.g. CGT event E4 as contained in s 104-70 of the 1997 Act).

The quantum approach

3.11 The quantum approach (which is no longer good law) is based on the proposition that a beneficiary can only be presently entitled to such amount(s) of trust income as they actually receive.

3.12 Further, any part of the net income of the trust estate which exceeds the amount to which the beneficiary is presently entitled is not income to which the beneficiary is presently entitled to pursuant to s 97 of the 1936 Act, with the result that the trustee is subject to tax on it under s 99A of the 1936 Act (unless the Commissioner exercises it discretion to cause it to be subject to tax under s 99).

3.13 As with the proportionate approach, where the net income of the trust estate for s 95(1) of the 1936 Act purposes is less than the trust law income, such that the beneficiary receives an amount which is greater than the amount included in their assessable income, the question arises as to how the excess is to be taxed (if at all).

4. Bamford

4.1 Bamford was a much anticipated decision. In the view of some[1] the decision was a missed opportunity to settle an area of the trust law and tax law that has been crying out for correction: *Bamford* at [17] citing Hill J in *Davis v Federal Commissioner of Taxation* (1989) 86 ALR 195 at 230.

Background to Bamford

4.2 Mr and Mrs Bamford were beneficiaries of a discretionary trust known as the Bamford Trust (the "**Trust**"). The trustee of the Trust was P&D Bamford Enterprises Pty Ltd. Mr and Mrs Bamford were also the directors and employees of P&D Bamford Enterprises Pty Ltd.

[1] Slater QC *Taxation Trust Income After* Bamfor'ds *Case*, 26th National TIA Convention, 2-4 March 2011

4.3 During the 2000 income tax year, the Trust made a contribution to an offshore superannuation fund on behalf of Mr and Mrs Bamford. The contribution was sourced from borrowings by the corporate trustee, in its capacity as trustee of the Trust.

4.4 For the purposes of determining the "net income" of the Trust for the 2000 income tax year, the corporate trustee (in its capacity as trustee of the Trust) claimed a deduction for both the contribution made to the offshore superannuation fund, and the interest on the borrowed funds used to make the contribution. The total deduction claimed was $191,701.

4.5 After taking into account of the deductions, the "net income" of the Trust for that year was distributed to specified beneficiaries of the Trust. Included in the distribution were Mr and Mrs Bamford, who both had specified amounts distributed to them.

4.6 Specifically, for that income tax year (i.e. the 2000 income tax year), the trustee of the Trust allocated amounts to certain beneficiaries of the Trust, including a payment of $34,000 each to Mr and Mrs Bamford. However, the trustee of the Trust did not have sufficient funds to pay the full amount of $34,000, and instead paid them $33,872, being what the trustee of the Trust thought was the total remaining trust funds.

4.7 The amount initially distributed by the trustee of the Trust was $187,530.

4.8 In 2005, the Commissioner of Taxation applied the anti-avoidance provisions so as to disallow the deductions of the Trust (for the 2000 income tax year) for the superannuation contribution and the interest. As a result of the denial of the deductions, for the purposes of the 2000 income tax year the Trust's taxable income exceeded its accounting income.

4.9 The decision essentially dealt with two things:

4.9.1 whether the 'proportionate approach' applied in the event that tax law income exceeds accounting / trust income; and

4.9.2 whether the trust deed of the trust could characterise an amount of capital gains as income of the Trust.

Application of the proportionate view

4.10 As a result of the denial of the deduction, the Trust's taxable income increased by $191,000. The Commissioner issued amended income tax assessments to both Mr and Mrs Bamford. Pursuant to the assessments, the Commissioner contended that Mr and Mrs Bamford were liable to tax on the increased 'net income' of the Trust based on the proportionate share of the amount by which the taxable income of the trust exceeded the accounting income.

4.11 Indeed, the Commissioner sought to assess Mr and Mrs Bamford on an extra $34,624, on the basis that that amount represented the 'share' of the additional $191,000 as their share (i.e. 18%) of the previous amount (i.e. $187,530) actually distributed.

4.12 However, the taxpayers argued that they should only be taxed on the difference between the $33,872 which they actually received, and the specific amount of $34,000 which was originally allocated to them (i.e. an amount of $128 each).

4.13 The High Court rejected the taxpayer's argument, and in doing so applied the "proportionate approach".

4.14 The High Court took a two step approach in dealing with this issue:

4.14.1 First – the High Court held that the term "*… income of the trust estate …*" as contained in s 97(1) of the 1936 Act refers to distributable income, being income as determined by the trustee taking into account the terms of the trust (e.g. the trust deed) and appropriate accounting principles.

4.14.2 Secondly – after ascertaining the "share" of the distributable income to which a beneficiary is presently entitled, s 97(1) of the 1936 Act then requires that "*… that share of the net income of the trust estate …*" be ascertained, being the shares of the taxable income and not the distributable income.

4.15 Further, it was held that the inclusion within s 97(1) of the 1936 Act of the defined phrase "*… net income of the trust estate …*" and the undefined term "*… the income of …* [the] *… trust estate …*" indicated that these were intended to have different meanings. As a result, the term "*… the income of …* [the] *… trust estate* " had a different and defined meaning for taxation purposes.

4.16 The Court at [45] held that the analysis of Sundberg J in *Zeta Force Pty Ltd v Commissioner of Taxation* (1998) 84 FCR 70 at 74-75 should be applied:

> *The resolution of the second issue of construction is to be found in the analysis by Sundberg J in* Zeta Force Pty Ltd v Commissioner of Taxation *… . His Honour dealt with the first issue of construction to the same effect as that just explained, saying:*
>
> > *"The words 'income of the trust estate' in the opening part of s 97(1) refer to distributable income, that is to say income ascertained by the trustee according to appropriate accounting principles and the trust instrument. That the words have this meaning is confirmed by the use elsewhere in Div 6 of the contrasting expression 'net income of the trust estate'. The beneficiary's 'share' is his share of the distributable income."*
>
> *Sundberg J then continued:*
>
> > *"Having identified the share of the distributable income to which the beneficiary is presently entitled, s97(1) requires one to ascertain 'that share of the net income of the trust estate'. That share is included in the beneficiary's assessable income. The expression 'net income of the trust estate' in par (a)(i) has the meaning given it by s 95(1) – taxable income as opposed to distributable income. The words 'that share' in par (a)(i) refer*

back to the word 'share' in the expression 'a share of the income of the trust estate', and indicate that the same share is to be applied to an income amount calculated according to a different formula (taxable income as opposed to distributable income). Since the income amount may differ according to which formula is applied, the natural meaning to give to 'share' where it appears for the second time is 'proportion' rather than 'part' or 'portion'. When Parliament wanted to convey the latter meaning, as it did in ss 99 and 99A, it used the word 'part'.

The contrast between the expressions 'share of the income of the trust estate' and 'that share of the net income of the trust estate' shows that the draftsman has sought to relate the concept of present entitlement to distributable income, and not to taxable income, which is, after all, an artificial tax amount. Once the share of the distributable income to which the beneficiary is presently entitled is worked out, the notion of present entitlement has served its purpose, and the beneficiary is to be taxed on that share (or proportion) of the taxable income of the trust estate."

4.17 For the 2000 income year, the "net income" of the Trust included the amount of $191,701 which should not have been claimed as a deduction in the tax return of the Trust. As a result, the High Court held that the assessable income of Mr and Mrs Bamford should include a share of that amount, equivalent to the share they each received of the distributable income.

Whether the trust deed could re-characterise amounts

4.18 The trust deed of the Trust gave the trustee the discretion to determine whether a particular receipt should be treated as income or capital.

4.19 The trustee relied on this power to pass a resolution to distribute the first $60,000 of net income, "*… including …* [the] *…. capital gain …*" to Mr and Mrs Bamford in equal shares.

4.20 The Commissioner argued that the capital gain was not income of the Trust. Further, since there was no income, no beneficiary could be 'presently entitled' to the amount in question, the trustee of the Trust should be assessed at the special rates.

4.21 The High Court held that the term "income" as contained in s 99A of the 1936 Act should be interpreted as income of the trust estate, as understood in trust law.

4.22 As a result, the net capital gain of the Trust became the income of the Trust after the trustee exercised its discretion to characterise the capital gain as income of the Trust.

Outcome for Trust Distributions

4.23 There is no room for doubt that Bamford establishes that:

4.23.1 income of the trust estate identified in s 97(1) of 1936 Act is to be determined according to any directions set out in the Trust Deed;

4.23.2 the share of the net income attributable to a beneficiary is to be determined in the same proportions in which the beneficiary enjoys the present entitlement to the share of the income of the trust.

4.24 In this first regard, the Court made it clear that the general rules regarding apportionment between capital and income of receipts and outgoings was largely based on assumptions which could be displaced by the terms of the trust instrument: Bamford at [17]. The general law of trusts operates to give meaning to the term "the income of the trust estate".

4.25 The determination of present entitlement to a share of the income is a process of trust administration. The decision of the Full Court of the Federal Court in *C of T v Totledge Pty Ltd* (1982) 40 ALR 385 at 393 is quoted in support: Bamford at [39]. The High Court distinguished its own decision in *C of T v Australia and New Zealand Savings Bank Ltd* (1998) HCA 53 (Bamford at [39]) as not relevantly addressing the issue. Finally, the Court observed that the Commissioner's lack of consistency in wishing to exclude "statutory income" from "income of the trust estate" did not assist his argument that "income" means "income according to ordinary concepts": Bamford at [41].

4.26 On the meaning of the term "share of the net income" the High Court adopted the proportionate approach advocated by Sunberg J in *Zeta Force* (discussed above).

4.27 What does this translate into for trustees making decisions in respect of trust distributions for the 2010 income year?

4.28 There are a number of relevant observations to be made.

4.29 First, if the Trust Deed provides a formula for determining the income of the trust then that formula will determine the entitlement of the beneficiaries to income. If, for example, the Deed contains words to the following effect:

> *"The net income of the trust is an amount equal to the amount determined in accordance with subsection 95(1) of the* Income Tax Assessment Act 1936 *but reduced by any amount which would otherwise be included by application of Division 207 of the* Income Tax Assessment Act 1997*".*

4.30 Throughout this paper "subsection 95(1) terms" means an amount adjusted for the franking credit gross up. The issue of grossing up is considered below in the context of using the full tax exemption including the franking rebate available to children.

4.31 Leaving aside the elimination of any gross up for franking credits (which itself is affected by the Streaming Amendments as discussed below) the amount of net income for trust law purposes

will equal the tax law income. The two will coincide so that there should, in the ordinary course, be no amount assessable to the trustee under s 99A of the 1936 Act.

4.32 Secondly, if the Trust Deed is silent then "ordinary income" principles apply. Just what they are is difficult to say. The ATO has expressed the view that income of a trust is income according to ordinary principles. This is not the same thing as accounting income determined in accordance with accounting principles. It requires a dissection of receipts into:

4.32.1 income according to ordinary principles;

4.32.2 income which is not ordinary income;

4.32.3 capital receipts.

4.33 Following that dissection, the expenses must be apportioned accordingly.

4.34 This is, of course, all too much. Many trust deeds will have a clause like that in Bamford which allows the trustee to determine whether a receipt is capital or income. Others will have very broad powers allowing the trustee to determine the basis on which income of the trust is to be worked out.

4.35 If these powers exist they should be used to avoid uncertainty brought about by the "ordinary income" approach. If they do not exist then the deed should be to give the trustee such a power. Whether such an amendment will amount to a resettlement, which might have adverse capital gains tax (and stamp duty) consequences, is discussed at **paragraphs xx** below.

4.36 Thirdly, because the proportionate approach has prevailed, a strict application of that rule will mean that great care needs to be taken when seeking to direct a specific amount of tax law net income to a particular beneficiary with absolute certainty e.g. the maximum amount to a child which escapes the punitive rates under Division 6AA of the 1936 Act. This issue is illustrated in the Examples which follow.

4.37 Fourthly, the High Court decision says nothing about streaming of trust income. The matter was not in issue. The uncertainty about streaming of income according to its character remained unabated, until the Streaming Amendments.

4.38 Finally, the ATO has done away with the benevolent "capital beneficiary" approach set out in Practice Statement PSLA 2005/1 (GA) on and from 13 October 2010.

Examples

4.39 The best way to illustrate these points is by way of example. In the examples which follow the following facts apply in relation to the A Family Trust for the income year ended 30 June 2010:

Receipts:

rent	$50,000
net capital gain	$100,000

Expenses:

rental expenses	$10,000
interest	$20,000

4.40 The interest relates to the rental property only. The discountable capital gain was made on the sale of shares in a listed company. The intended beneficiaries are Mr and Mrs A and their two children both under 18.

4.41 Because of the low income rebate the following no-tax thresholds apply to minors:

Income Year end 30 June	**$**
2010	3,000
2011	3,333

4.42 If the income constitutes fully franked dividends the cash payment thresholds and grossed up taxable income amounts are:

Income Year end 30 June	**$ cash**	**$ taxable income**
2010	6,300	9,000
2011	7,000	10,000

4.43 These figures have considerable significance for trustees seeking to hit the no tax "sweet spot" for a distribution to a child.

(a) Subsection 95(1) terms apply – no "balance approach"

4.44 The taxable capital gain is $50,000. Accordingly, the distributable trust income is $70,000.

4.45 For 2010 a minor may be distributed $3,000 with no tax liability if entitled to the low income rebate (see comments above).

4.46 The trust distribution minutes might give effect to the following:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000

70,000

4.47 The tax law results will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.48 The cash in the trust will include the $50,000 covered by the 50% general CGT discount. This is not income and can be dealt with as capital. As this is a discretionary trust it can be distributed without tax consequences.

(b) Ordinary income applies – no "balance approach"

4.49 In this instance the trust distribution minutes will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	7,000
Mr A	7,000
	20,000

4.50 The tax law results will be:

	$
Child 1	$3{,}000 + {}^{3,000}/_{20,000} \times \$50{,}000$
Child 2	$3{,}000 + {}^{3,000}/_{20,000} \times \$50{,}000$
Mrs A	$7{,}000 + {}^{7,000}/_{20,000} \times \$50{,}000$
Mr A	$7{,}000 + {}^{7,000}/_{20,000} \times \$50{,}000$

4.51 The final results:

	$
Child 1	10,500
Child 2	10,500
Mrs A	24,500

Mr A	24,500
	70,000

4.52 This is a strict application of the proportionate approach.

4.53 Each of the children will pay tax on $7,500 at the Division 6AA punitive rates of 45%. This is not a good result.

(c) Subsection 95(1) applies – "balance approach" used

4.54 Trust minutes:

	$
Child 1	3,000
Child 2	3,000
Mrs A	half of the balance
Mr A	half of the balance

4.55 Trust income entitlements:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.56 The tax law result:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.57 This is the same outcome as where no "balance approach" is applied – but see below for the effect of a tax adjustment.

(d) Ordinary income applies – "balance approach" used

4.58 Trust minutes

	$
Child 1	3,000
Child 2	3,000
Mrs A	half of the balance
Mr A	half of the balance

4.59 Trust income created will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	7,000
Mr A	7,000
	20,000

4.60 The tax law results will be:

	$
Child 1	$3{,}000 + {}^{3,000}/_{20,000} \times \$50{,}000$
Child 2	$3{,}000 + {}^{3,000}/_{20,000} \times \$50{,}000$
Mrs A	$7{,}000 + {}^{7,000}/_{20,000} \times \$50{,}000$
Mr A	$7{,}000 + {}^{7,000}/_{20,000} \times \$50{,}000$

4.61 The final results:

	$
Child 1	10,500
Child 2	10,500
Mrs A	24,500
Mr A	24,500
	70,000

4.62 Again there is no difference. However, the "balance approach" is more realistic because it is unlikely that the trust income or tax law income will be known as at any 30 June. In reality these figures are not known until the accounts are drawn later in the calendar year.

(e) Tax Law Adjustments

4.63 It is often important to anticipate an adjustment to the trust's tax law income especially where there is something contentions going on.

4.64 As has been seen the tax law result will follow on a proportionate basis the entitlements to income created under the Deed. To test the outcome it is assumed in the above examples that the trustee failed to recognise $10,000 of rental income (say the trustee at first considered that the income was to be deferred until the 2011 income year) but was in fact wrong about this.

4.65 How do the various approaches deal with such an adjustment?

Example (a) – subsection 95(1) applies (but no "balance approach")

4.66 The trust law entitlements and tax law results were the same:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.67 The tax law adjustment will increase both the trust law entitlement and the tax law income by $10,000. The Trustee has not dealt with this $10,000 and, without an operative default beneficiary clause, it will be assessed to the Trustee under section 99A of the 1936 Act.

4.68 The trust law entitlements and tax law result will be:

	$
Child 1	3000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
Trustee	10,000
	80,000

4.69 However, if there is no streaming of the capital gain (with the effect that all beneficiaries are entitled to a proportionate part of the capital gain) that part of the capital gain reflected in the income to which no beneficiary is presently entitled will be grossed up for the loss of the 50% general CGT discount. Five eighths of the $10,000 adjustment assessed to the Trustee is capital gain. As a result the share of the net income assessable to the Trustee will be increased by $6,250.

4.70 The final result will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
Trustee	16,250
	86,250

4.71 This is a costly outcome.

Example (c) – subsection 95(1) but using a "balance approach".

4.72 The trust law entitlement and tax law result were the same.

	$
Child 1	3,000
Child 2	3,000
Mrs A	half of the balance
Mr A	half of the balance

4.73 The unadjusted result was:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000
Mr A	32,000
	70,000

4.74 The adjusted trust law entitlement and tax law result will be:

	$
Child 1	3,000
Child 2	3,000
Mrs A	32,000 + 5,000
Mr A	32,000 +5,000
	80,000

4.75 The "balance approach" together with adoption of s 95(1) terms directs all of the tax law result from an adjustment made by the ATO to the balance beneficiaries.

4.76 If the balance distribution has been used Mr and Mrs A will "enjoy" a further $5,000 of income entitlement (it now having been correctly determined) and a further $5,000 of tax law net income each. No amount will be assessed to the trustee.

4.77 There is an argument that the beneficiaries have not become presently entitled to the amount of the adjustment to the trust law net income as it was not ascertained at the end of the income year. In the writer's opinion the trust law net income was always the amount as correctly adjusted by the ATO. There was never any uncertainty about it. It is simply the case that the trustee and ATO had not properly determined the correct quantum of income.

4.78 In practical terms how have the Courts looked at the "balance approach"? It has not come up that often.

4.79 The decision of Cooper J in *BRK (Bris) Pty Ltd v C of T* [2001] FCA 164 might at first blush give cause for concern. There the Court considered the operation of the default beneficiary clause in the Trust Deed. The distributions had been:

1993 income year:

"Hendon Unit Trust 100%

and Resolved that should the Commissioner of Taxation disallow any amount as a deduction or include any amount in the assessable income of the Trust, such amount or amounts are to be deemed distributed on 30th June 1993 in the same proportions as listed above to the beneficiaries listed above".

1994 income year:

(a) The sum of $304,021.72 to Westside Commercial Centre Pty Ltd as trustee of the Hendon Unit Trust for its absolute benefit.

(b) The following sums to the following beneficiaries for their absolute respective benefits: NIL

(c) The Balance to Jessica Wagner and Bill Wagner equally between them for their absolute benefit.

1995 income year:

Hendon Unit Trust	*First $220,000*
Northbourne Trust	*Next $100,000*

Wilhelm J Wagner and Jessica O Wagner	*Remainder of balance equally*

4.80 The same "variation of income" clause as in 1993 applied in this year.

4.81 It would appear that the Trust Deed did not adopt subsection 95(1) terms and that income was ordinary income.

4.82 It was found that the Hendon Unit Trust was not an object of the Trust and the distribution of income to it failed. The default beneficiaries clause distributed income in default of appointment to the beneficiaries described in the Schedule to the Deed as tenants in common. This was the usual wide class of family objects.

4.83 The Court concluded that the default beneficiary clause did not operate as at 30 June because the trustee had a reasonable time after the end of the income year in which to decide to distributed or accumulate.

4.84 The question arose as to whether the balance clause in the 1994 and 1995 determinations operated to take the amounts which the Trustee had attempted to distribute to the Hendon Unit Trust to Mr and Mrs Wagner. It was concluded that this was not the effect of the distribution minute and, as a result, the Trustee was assessable under section 99A.

4.85 At [40] Cooper J concluded:

> *"In my judgment the submission is misconceived. In the 1994 income year the clear intention of the applicant was to appoint to Mr and Mrs Wagner only so much of the Trust income, if any, as exceeded $304,021.72 in addition to any income in excess of that amount in the event that the appointment to WCC should fail. The position is no different in respect of the 1995 year. The trustee purported to appoint discrete amounts of income to the Hendon Unit Trust as to the first $220,000 and to the Northbourne Trust as the next $100,000. Finally, as to any remainder after the application of the first $320,000 of income, that remainder was to be appointed to Mr and Mrs Wagner; they did not as a matter of construction or intention on the part of the trustee, take by default all of the income in the event of failure of the other two appointments."*

4.86 Rather than being a cause for concern about the "balance approach" the decision of Cooper J on this point supports its operation. The specific quantum entitlements fix the income (and tax where s 95(1) terms apply) at the amount specified in the Trustee's determination. If the gift fails it does not flow to the balance beneficiary but to the default beneficiary or, in the alternative, there is no such entitlement created, giving rise to a s 99A assessment to the trustee.

4.87 Further comfort can be obtained from observations made in *C of T v Ramsden* [2005] FCAFC 39. In that case the Court was concerned with the issue whether a beneficiary had effectively renounced a distribution of income.

4.88 The distribution minutes for the 1996 income year provided:

"Steve Hart Family Holdings No.2	*$17,295*
Steve Hart Family Holdings No.3	*$6,639*
Unlimited Aerobatic Discretionary Trust	*$34,810*
The Adcock Practice Trust	*$429,000*
Troy B Hart	*$4,750*
Steven I Hart	*The Balance"*

4.89 It was agreed that the Adcock Practice Trust did not qualify as a beneficiary. The default beneficiary clause provided for income which had not been appointed prior to year end to be held for Steven Hart and his three children as tenants in common. The ATO assessed each of the default beneficiaries to one quarter of the amount which had failed to be appointed to the Adcock Practice Trust.

4.90 The argument was pressed before the primary judge that the income should pass by way of the balance distribution to Steven Hart: Ramsden at [38] to [41]. Justice Spender's rejection of this argument was confirmed by the Full Court. It was observed at [2005] FCAFC 39 at [72]:

> *"We agree with this construction. 'The Balance' does not include the amounts which precede "The Balance" in the resolution of 30 June 1996.*
>
> *'The Balance' is the Income of the Trust for the year ended 30 June 1996 other than the amounts which precede it in the resolution in question, whether effectively appointed or not".*[2]

4.91 This observation supports the "balance approach" taken in this paper where there have been effective distributions. Note, however, that it will not work where a distribution is ineffective. In such a case the adjustment will be assessed to the default beneficiary, if there is one, or to the trustee.

Example (d) – Ordinary Income with balance approach applying

4.92 The trust law entitlements were:

	$
Child 1	3,000

[2] [2005] FCAFC 39 at para. 72.

Child 2	3,000
Mrs A	half of the balance
Mr A	half of the balance

4.93 Trust income entitlements:

	$
Child 1	3,000
Child 2	3,000
Mrs A	7,000
Mr A	7,000
	20,000

4.94 The tax law result was:

	$
Child 1	10,500
Child 2	10,500
Mrs A	24,500
Mr A	24,500
	70,000

4.95 When the tax law income is adjusted by $10,000 there is no change to the trust law result. The tax law result will be:

	$
Child 1	$10,500 + {}^{10,500}/_{70,000} \times \$10,000$
Child 2	$10,500 + {}^{10,500}/_{70,000} \times \$10,000$
Mrs A	$24,500 + {}^{24,500}/_{70,000} \times \$10,000$
Mr A	$24,500 + {}^{24,500}/_{70,000} \times \$10,000$

4.96 The final result will be:

	$
Child 1	12,000
Child 2	12,000
Mrs A	28,000
Mr A	28,000

	80,000

4.97 The result has only become worse from a Division 6AA income perspective.

Will a "default beneficiary" clause in the Deed assist?

4.98 An income default beneficiary clause would be expressed something like:

> *"If the Trustee has not determined to distribute all of the net income of the Trust by the end of the Income Year the Income Default Beneficiary will be absolutely entitled to that part of the net income which has not been distributed."*

4.99 The term "Income Default Beneficiary" will be appropriately defined to identify individuals or companies.

4.100 In Example (a) – subsection 95(1) terms but no "balance approach" – a default beneficiary clause would have deflected the tax adjustment from the trustee to the default beneficiary.

4.101 In Example (b) – ordinary income but no "balance approach" – the default beneficiary clause would have no effective operation as all of the trust law/tax law income has been accounted for.

4.102 The trust entitlements were:

	$
Child 1	3,000
Child 2	3,000
Mrs A	7,000
Mr A	7,000
	20,000

4.103 The tax law result was:

	$
Child 1	10,500
Child 2	10,500
Mrs A	24,500
Mr A	24,500
	70,000

4.104 If the tax law income is increased by $10,000 the trust law income does not alter. The tax law adjustment is apportioned according to the trust law income apportionments, as follows:

	$
Child 1	10,500 + $^{3,000}/_{20,000}$ x 10,000
Child 2	10,500 + $^{3,000}/_{20,000}$ x 10,000
Mrs A	24,500 + $^{7,000}/_{20,000}$ x 10,000
Mr A	24,500 + $^{7,000}/_{20,000}$ x 10,000[3]
	70,000

4.105 The final tax results will be:

	$
Child 1	12,000
Child 2	12,000
Mrs A	28,000
Mr A	28,000
	80,000

4.106 In Example (c) – subsection 95(1) terms and a "balance approach" – the default beneficiary clause has no role to play because the adjustment will always be directed to the balance beneficiary.

4.107 In Example (d) – ordinary income and "balance approach" – the default beneficiary clause has no need to operate because the tax adjustment will simply be apportioned in accordance with the trust law entitlements which don't change.

Summary re Tax Adjustments

Trust Accounting Basis	Tax Law Income	Trust Income	Adjustment to (if no default beneficiary)	Adjustment to (if there is a default beneficiary)
subsection 95(1) – no "balance approach"	+ $100	+ $100	Trustee	Default Beneficiary
subsection 95(1) – "balance approach"	+ $100	+ $100	Balance Beneficiaries	Balance Beneficiaries
ordinary income – no "balance approach"	+ $100	no change	All Beneficiaries	All Beneficiaries
ordinary income – "balance approach"	+ $100	no change	All Beneficiaries	All Beneficiaries

[3] The proportions remain the same whether the trust law or tax law results are used.

Guidance from Bamford

4.108 As the High Court observed in Bamford at [17]:

> *"… both sides in argument on the present appeals accepted that whichever of the competing constructions of Div 6 were accepted examples could readily be given of apparent unfairness in the resulting administration of the legislation"*

4.109 In reaching the conclusion that the terms of the Trust Deed determine the trust income to which a beneficiary may be made entitled the High Court has gone very far towards resolving most of the problems and uncertainties which confronted practitioners and the trustees and beneficiaries they advise. With a good understanding of the terms of the Trust Deed as they effect trust distributions most distribution problems can be addressed.

4.110 As has been demonstrated in the above worked examples adopting a s 95(1) terms plus "balance approach" achieves the following:

4.110.1 the quantum of tax distribution to children can be locked in.

4.110.2 any "normal" tax adjustment will flow to the balance beneficiaries.

4.110.3 if used in conjunction with a default beneficiary clause ineffective distributions can also be dealt with.

4.111 The subsection 95(1) but without a "balance approach" can lead to:

4.111.1 an assessment of the tax adjustments to the trustee under section 99A;

4.111.2 clawback of any general CGT discount.

4.112 This can be addressed by using a default beneficiary (of course the default beneficiary should not be a company where the general CGT discount is involved).

4.113 The balance approach together with a considered default beneficiary is to be preferred as the outcome is more predictable.

4.114 The ordinary income approach is problematic because it is:

4.114.1 too difficult to calculate what is net ordinary income;

4.114.2 and tax law adjustments will be spread across all beneficiaries (as there is no adjustment to the net income).

5. Div 7A Amendments

5.1 Division 7A of Part III of the 1936 Act deals with accessing wealth in private companies without accounting for the tax that would otherwise be payable on the value accessed. It focuses on three means of accessing wealth in private companies – payments from a private company, loans from a private company or the forgiveness of a debt by a private company to an associate of that company.

5.2 In 2010 there were two broad changes to the Division 7A interacts with trusts:

5.2.1 The Div 7A Amendments; and

5.2.2 The Commissioner's position in *Taxation Ruling 2010/3* and *Practice Statement Law Administration* 2010/4.

5.3 The changes to Division 7A include the insertion of an introductory note to Division 7A stating:

> An amount may also be included in the assessable income of a shareholder or shareholder's associate if:
>
> (a) a company has an unpaid present entitlement to income of a trust; and
>
> (b) the trustee makes a payment or loan to, or forgives a debt of, the shareholder or associate.
>
> (See Subdivisions EA and EB.)

5.4 This note is of interest as it strongly suggests that Subdivision EA is a 'code' which is intended to capture arrangements where there is an unpaid present entitlement subsisting between a trust and a corporate beneficiary and there is then a loan, payment or forgiveness that occurs between the trustee and a shareholder or an associate of a shareholder in the corporate beneficiary.

5.5 This should be contrasted with the position in the ATO *Taxation Ruling* 2010/3 where the ATO assert that subdivision EA has much more limited effect, where they generally restrict its operation to the situation where there is a sub-trust in existence between a trustee and a corporate beneficiary and there is then loan, payment or forgiveness involving a shareholder or an associate of a shareholder and the trustee of the sub-trust.

5.6 In the 31 March 2010 NTLG meeting the professional bodies questioned the ATO as to whether the introduction of this provision into Division 7A cast doubt on the position in their draft ruling. The meeting agenda includes the following discussion:

> The ATO does not see a conflict between the legislation of provisions dealing with unpaid present entitlements and the position set out in Draft Ruling TR 2009/D8.

This is because, contrary to the premise of the question, under Draft Ruling TR 2009/D8 unpaid present entitlements will retain that status for Division 7A purposes in many situations, including where:

- the amount representing the UPE is physically held on sub-trust for the sole benefit of the private company beneficiary;
- the amount representing the UPE is being used by the trustee but all benefits from this use are held for the sole benefit of the private company; or
- the private company beneficiary is not aware and cannot be taken to be aware that the funds representing its UPE are being used for the potential benefit of any or all discretionary objects of the trust (rather than being physically set aside or used for its sole benefit).

The ATO has appropriately consulted with Treasury prior to and during the drafting of TR 2009/D8.

Provisions within Division 7A dealing with unpaid present entitlements will continue to have their intended application and there is no inconsistency between the Exposure Draft legislation and the draft Ruling.

Use of assets

5.7 As was announced in the 2009/10 Federal Budget the use of assets owned by private companies, or owned by trusts where there is a present entitlement owing to a private company may be subject to tax after 1 July 2009.

5.8 The way in which the use of assets will become subject to tax is through the amendment of the definition of the term 'payment' in Division 7A so that it extends to the provision of an asset (other than a transfer of property) for use by an entity. Consistent with the present operation of Division 7A the provision of the asset will only result in Division 7A consequences where the asset is provided to a shareholder or associate of a shareholder.

5.9 For the purposes of Division 7A the payment will occur when the use of the asset occurs.

5.10 A payment will also arise however where the asset is not used, but is available for use. The examples in the EM are illustrative of when it will be the right to use the asset, and not its use, that is subject to the Division 7A rules.

> ***Example (right to use from EM)***
> ***Brian is a shareholder of a private company that owns a luxury yacht. He does not have a formal agreement with the company in relation to the yacht, however, he takes the yacht out every second weekend.***
>
> ***Brian keeps the yacht at the company's business premises, but takes the key home. Brian stores several personal items on the yacht.***
>
> ***Brian's fortnightly use of the yacht is a payment under Division 7A. The availability of the yacht for Brian's use is also subject to Division 7A because the yacht is not readily available for use by the company. The company would need to arrange with Brian to***

get the key and for the removal of Brian's personal items before using the yacht. That is, the asset is available for Brian's use to the exclusion of the company.

Example (use from EM)
Marina is a shareholder of a private company that owns a city apartment. The apartment is generally available for rent. However, Marina asks the company not to rent the apartment out for a week so that she and her family can use the apartment over a long weekend. Marina's use of the apartment is a payment for the purposes of section 109CA.

5.11 An issue that arose on consultation over the draft legislation giving effect to these changes was whether the mere availability of assets to a shareholder or associate would result in the shareholder or associate being treated as having the asset available for their use. The EM again includes an example where there a payment is not taken to arise where an asset is available as a result of a general entitlement to use an asset without actual use of the asset.

Example (mere entitlement from EM)
Peter is a shareholder of a private company that owns five cars for company use. Shareholders and their associates have general permission to use the cars on weekends if they are not being used for company business. Peter regularly takes one of the cars home.

Peter's use of the car that he takes home will be subject to Division 7A. This will include driving the car (actual use) and the availability of the car for his use to the exclusion of the company, such as when it is parked at home, or at a restaurant that Peter is visiting.

Although Peter may have general permission to use all five of the cars, he does not use all of them for the purposes of Division 7A. The four cars that Peter leaves at the company premises are available for the company to loan to another shareholder, employee, customer, or other party. That is, these cars are not available to Peter to the exclusion of the company.

5.12 The EM also includes examples of where an asset is available to more than one shareholder or associate and it is necessary to determine who is taxed. The EM suggests and apportionment of the taxable value to the person who is the real recipient of the benefit. One example sets out that a minor that benefits should not be taken to receive a Division 7A payment, where another sets out that incidental use by a spouse of a vehicle provided to a shareholder would not result in the spouse being taxed on the benefit provided.

5.13 In valuing the payment taken to be made it will be the amount that would have been paid for the use of the asset in an arm's length dealing less any consideration paid that will be determined to be the payment for Division 7A purposes.

5.14 There are a number of exceptions from the payment provisions applying, including one not previously announced dealing with residential property:

5.14.1 Minor benefits – if the provision of the asset would have been a minor benefit under section 58P of the FBTAA had it been provided to an employee then the benefit will be disregarded for Division 7A purposes

5.14.2 Otherwise deductible payments – if a once off deduction would have been available to the shareholder or their associate in connection with the use of the asset then there will be no benefit to be taken into account for Division 7A purposes.

5.14.3 Dwellings – the use of a dwelling can be exempt where the following conditions are satisfied:

5.14.3.1 the entity or their associate is carrying on a business;

5.14.3.2 the entity or their associate uses or is granted or has a lease, licence or other right to use land, water or a building for the purpose of carrying on the business; and

5.14.3.3 the provision of the dwelling to the entity is connected with that use or with that lease, licence or other right to use the land, water or building to carry on the business.

5.14.4 Main residences – the provision of a dwelling that is a person's main residence does not result in a Division 7A payment where:

5.14.4.1 The provider of the dwelling is a private company;

5.14.4.2 The private company acquired the dwelling before 1 July 2009; and

5.14.4.3 The private company would pass COT from the time that the dwelling was acquired until the end of the time that a payment could be taken to be made under Division 7A.

5.14.5 Vacant land – if the exception for a dwelling or a main residence applies, it will extend to adjacent land in the same way as occurs in the main residence exemption.

Corporate limited partnerships

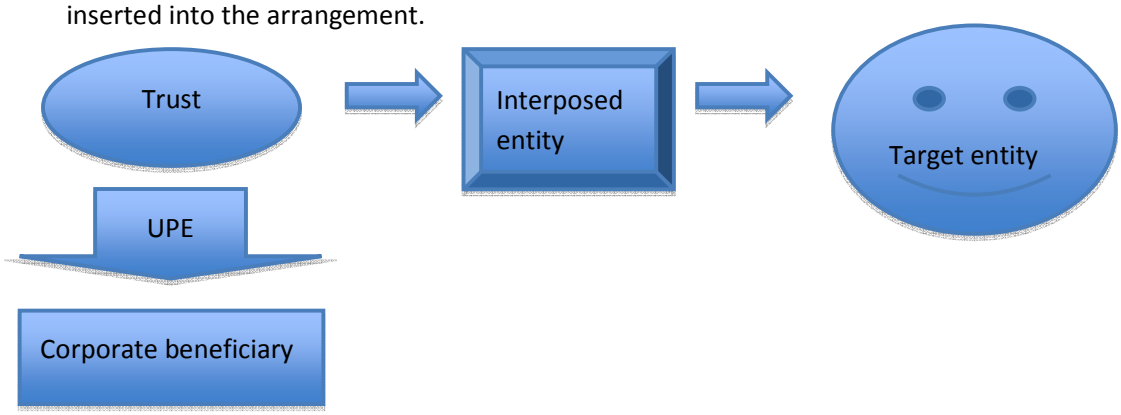
5.15 Closely held corporate limited partnerships (limited liability partnerships) will also now be subject to Division 7A. A corporate limited partnership will be closely held where it has fewer than 50 members or where an entity has, directly or indirectly, for the entity's own benefit, an entitlement to 75% or more of the income and capital of the partnership.

Interposed entities

5.16 The Div 7A Amendments fix two drafting issues in relation to the use of interposed entities.

5.17 The Division 7A legislation as originally drafted allowed for a payment by a private company through an interposed entity to be treated as a payment for Division 7A purposes.

5.18 The legislation did not however on a plain reading, allow for a trust where there was an unpaid present entitlement, to be deemed to have made a payment where an interposed entity was inserted into the arrangement.



5.19 A payment from the trust through an interposed entity to a target entity will now be caught by Division 7A if a reasonable person would consider that a loan or payment made to the interposed entity was made to enable a loan or payment to be made by the interposed entity to the target entity.

5.20 Consistent with the current operation of Subdivision EA however, a payment through to the target entity will only result in a Division 7A deemed dividend if it is referable to a reduction in a present entitlement that is in itself attributable to an unrealised gain in the trust.

5.21 The Div 7A Amendments also ensures that where an unpaid present entitlement is owed to a company by a trust, but the loan, payment or forgiveness that occurs does not involve the trust that owes the unpaid present entitlement, that Subdivision EA still has effect.

5.22 Subdivision EA will apply to treat a loan or payment from a trust as being a Division 7A loan or payment to the extent that the loan or payment is referable to an unpaid present entitlement owed to a private company where that amount has not already resulted in a Division 7A loan or payment.

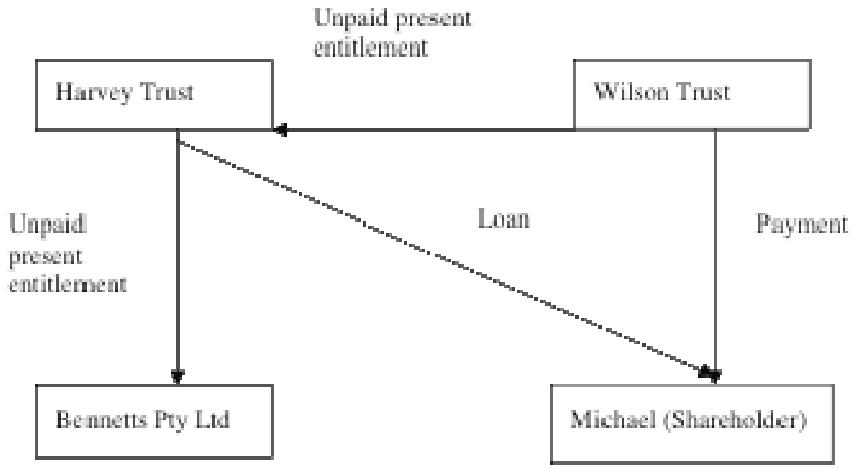
Example (interposed trust from EM)
Michael is a shareholder of Bennetts Pty Ltd and Bennetts Pty Ltd is a beneficiary of Harvey Trust. In the 2009-10 income year, Michael receives a payment from the trustee of the Wilson Trust, which is attributable to an unrealised gain. He receives this payment

because of his shareholding in Bennetts Pty Ltd. Michael also receives a $2,000 non-compliant Division 7A loan from the Harvey Trust.

Bennetts Pty Ltd is not presently entitled to an amount from the net income of the Wilson Trust. However, Bennetts Pty Ltd is entitled to $10,000 from the net income of the Harvey Trust (the first interposed trust) and Harvey Trust is presently entitled to $10,000 from the net income of the Wilson Trust. These amounts remain unpaid.

The loan made by the Harvey Trust to Michael will be included in Michael's assessable income under ordinary operation of subsection 109XA(2).

Bennetts Pty Ltd is taken to be presently entitled to $8,000 from the Wilson Trust, which is the unpaid present entitlement of $10,000 from the Harvey Trust, reduced by the $2,000 loan amount that is included in Michael's assessable income under another provision of Subdivision EA.



Loan back arrangements

5.23 Subdivision EA as currently drafted only captures payment arrangements where the payment is a reduction of a present entitlement that is referrable to an unrealised gain.

5.24 To circumvent these rules, apparently it had been suggested that the following arrangement could be entered into:

5.24.1 An unpaid present entitlement exists to a private company, say of $100,000.

5.24.2 A payment is made by the trustee of the trust to a beneficiary of an amount far in excess of the UPE, for example $1 million.

5.24.3 The amount in excess of the UPE is then loaned back to the trustee, being $900,000.

5.24.4 Thus, the beneficiary now has a credit loan of $900,000.

5.24.5 In future years the trustee appoints income to the company and uses the funds to repay the credit loan.

5.25 The need for there to be a payment referrable to a reduction of an unrealised gain will be removed where the payment made to a beneficiary is in reduction of a loan made on or after 1 July 2009 where a reasonable person would conclude that the trustee obtained the loan in order to make the payment.

Amendment to distributable surplus definition

5.26 The definition of distributable surplus will be amended so that amounts that have been deemed to be dividends as a result of the operation of Subdivision EA will be removed from the distributable surplus (by being correctly included as non-commercial loans).

Forgiveness of 109XB loans

5.27 There is a drafting problem that will be rectified so that the forgiveness of a loan by a trustee that has already been deemed to be a dividend will not result in a subsequent dividend. The law already applies in this way to the forgiveness of a debt owed to a private company by a shareholder that has already been deemed to receive a dividend under Division 7A.

Dividend set-off

5.28 Another drafting problem dealing with dividend set-offs will also be rectified.

5.29 At present, where a private company makes a loan that is deemed to be a dividend and later pays an unfranked dividend that is set off against that loan the later dividend is not included in assessable income.

5.30 The ability to disregard the later dividend does not apply where the loan was made by the trustee of a trust and where the deemed dividend arose under section 109XB.

5.31 The ability to disregard a later unfranked dividend offset against a loan from a trustee is being introduced.

Setting off employment entitlements

5.32 Another unusual aspect of the interaction of Division 7A generally and Subdivision EA has been that employment related payments that are offset against loans by trustees do not count as repayments if there is a borrowing of a similar or greater amount to the amount repaid. This is in contrast to setting off such a payment against a loan by a company where the repayment is taken into account even if there is a further borrowing.

5.33 This anomaly is to be rectified.

Borrowing to repay

5.34 Under the previous law a repayment is disregarded where the repayment is made where a reasonable person would conclude the repayment was made in order to borrow a similar or greater amount. This prevents a person from borrowing funds during a financial year, repaying on 30 June, and then reborrowing the amount on 1 July.

5.35 While the law has operated in this way (with some exceptions for repayments that occur by way of offsetting assessable amounts such as the wages noted above) it arguably has not operated where, instead of repaying to borrow, a person borrows to repay. This was be remedied so that a borrowing to repay will also activate section 109R.

> ***Example (from EM)***
> ***Alicia obtains a loan of $10,000 from Cleary Pty Ltd. Alicia has until the lodgment day to repay the loan. Two weeks before the lodgment day Alicia obtains a further $10,000 from Cleary Pty Ltd. She then repays the original $10,000 loan a week before the lodgment day.***
>
> ***The repayment of the original $10,000 loan is not a repayment for the purposes of section 109D, because Alicia has borrowed a similar amount from Cleary Pty Ltd and in this case a reasonable person would conclude that the loan was obtained in order to make the repayment of the original $10,000.***
>
> ***The original $10,000 loan is treated as a deemed dividend subject to the distributable surplus of the private company.***

Adding back payments for Division 7A purposes

6. Streaming

6.1 The paper will no consider the importance of, and ability to, stream as it stood before the Streaming Amendments. Then it will consider the Streaming Amendments.

Pre-Streaming Amendments

6.2 As can be seen from the illustrations above the ability to stream income according to its character is very important. This is particularly the case for franked dividends and capital gains but there are other forms of income with tax characteristics that may also be important e.g. income from a foreign source, income which has been subject to TFN withholding tax.

6.3 The decisions in Bamford tell us nothing about streaming income for tax purposes.

6.4 Most modern trust deeds will give the trustee power to distinguish between classes of income and to characterise a particular amount of income as having been derived from a particular source. The Deed should also allow the trustee to allocate expenses to the different classes of income.

6.5 The law regarding streaming after the decision in *CPT Custodian Pty Ltd v Commissioner of State Revenue [2005] HCA 53* ("**CPT Custodian**") was quite uncertain. The decision of the High Court in *Charles v C of T [1954] HCA 16* ("**Charles**") has always been the centre of gravity of the character flow through approach. The decision in Charles was heavily criticised by the Court in CPT Custodian. The question is whether that criticism went to the maintenance of character or is restricted to the characterisation of the interest in the trust fund by looking through to the underlying assets.

6.6 The decision of the High Court in CPT Custodian, in the writers' views, stands for the proposition that a beneficiary has an equitable interest in the residue of the trust fund after the Trustee's indemnity has been satisfied. This residue is characterless, whether it be income or capital, as the trustee may at any time satisfy its right to be indemnified from the receipts (which themselves have character).

6.7 Notwithstanding these problems the ATO has consistently taken the view that the character of the income in the hands of the beneficiary is taken from the character of the receipts of the Trustee[4] even after taking into account the decision in *CPT Custodian*[5].

6.8 In the non-binding ruling IT2328 (now withdrawn) it was observed:

> *"For income tax purposes where a beneficiary in a trust estate is presently entitled to the net income or a share of the net income of the trust estate, that income as a general principle has the same character in the hands of the beneficiary as it had in the hands of the trustee."*

6.9 The most significant streaming issues concern capital gains and dividends. In the case of capital gains Division 115 of Part 3-1 of the 1997 Act proceeds on an implication that income entitlements will take on at least some part of the character of the capital gains derived by the trustee. There is no clear legislative follow through. The guidance found in Sesction 115-200 of the 1997 Act establishes the implied maintenance of character:

> *"This Subdivision sets out rules for dealing with the net income of a trust that has a net capital gain. The rules treat parts of the net income attributable to the trust's net capital gain as capital gains made by the beneficiary entitled to those parts."*

[4] see in particular ATO ID 2008/51 dealing with Division 13.3A of the SIS Regulations.

[5] see Taxation Ruling STR 92/13, IT2328, IT2512, IT2004 (withdrawn) and ATO ID 2007/108 (which is concerned with foreign sourced income and in respect of which subsection 6B(2A) of the 1936 Act also comes into consideration).

6.10 Subsection 115-215(1) is the nub of the provisions:

> *"The purpose of this section is to ensure that appropriate amounts of the trust estate's net income attributable to the trust estate's capital gains are treated as a beneficiary's capital gains when assessing the beneficiary, so:*
>
> *(a) the beneficiary can apply capital losses against gains; and*
>
> *(b) the beneficiary can apply the appropriate discount percentage (if any) to gains."*

6.11 The process is described as attribution rather than maintenance of source character. This may be the necessary distinction to make the rules work. There is, however, no guidance about how the attribution is to be carried out.

6.12 What is clear is that if there is no trust income to which the beneficiary is presently entitled there can be no attribution. This is a major issue where there is no trading income but there are capital gains in the Trust. Use of s 95(1) terms to describe income overcomes this problem and makes the case for attribution much clearer. The capital gain (or at least 50% of it) will be included in the income. The connection for Subdivision 115-C purposes is very clear.

6.13 The ATO has had to resort to the artificiality of the "capital beneficiary approach" in PS LA 2005/1 (GA) to achieve this sensible outcome – but this practice statement was withdrawn following Bamford.

6.14 The issues with streaming can be readily appreciated in the context of capital gains and the 50% general CGT discount. The streaming issue is, of course, the denial of the 50% CGT general discount when a trust to company distribution is in play.

6.15 Maintaining the example used above in which there is a net capital gain of $100,000, and gross rental income of $50,0000 and net rental income of $20,000.

6.16 In this instance the trustee wishes to cause the capital gain to be assessed in the hands of an individual (say Mrs A) and the net rental income in the hands of a company, A Co. If it is assumed that the Trust Deed has all of the usual income characterisation and streaming provisions and the Deed adopts subsection 95(1) terms, the outcome readily appears.

6.17 The income entitlements are:

	$	
A Co	20,000	comprising net rental income
Mrs A	50,000	comprising the capital gain
	70,000	

6.18 If the ATO took the view that streaming was unobtainable the outcome would be:

	$	$ Total
A Co	5,714 + taxable capital gain $28,572	34,286
Mrs A	50,000	50,000
		84,286

6.19 The other area of concern is franking credits. At least there is a ruling on this aspect of streaming, *Taxation Ruling* 92/13 (repealed as of 22 June 2011 because of the Streaming Amendments). The provisions of Subdivision 207-B and in particular ss 207-45 to 207-57 are consistent with flow through of the franked character of a dividend.

6.20 The fact the Example set out immediately below s 207-35(3) of the 1997 Act depends on character maintenance. It is worthwhile setting this Example out in full:

> *"A franked distribution of $70 is made to the trustee of a trust in an income year. The trust also has $100 of assessable income from other sources. Under subsection (1) the trust's assessable income includes an additional amount of $30 (which is the franking credit on the distribution). The trust has a net income of $200 for that income year.*
>
> *There are 2 beneficiaries of the trust, P and Q, who are presently entitled to the trust's income. Under the trust deed, P is entitled to all of the franked distribution and Q is entitled to all other income.*
>
> *The distribution flows indirectly to P (as P is entitled to a share of that net income and has a 100% share of the distribution under section 207-55). P therefore has an amount of assessable income that is equal to its share of the distribution. Under this subsection, P's assessable income also includes the full amount of the franking credit (as P's share of the franking credit on the distribution is $30 under section 207-57). Q's share of the net income therefore does not include any of the franking credit."*

6.21 Clearly the legislation contemplates maintenance of character for the purposes of dividend imputation.

Commissioner's Concern of Division 6 Abuses

6.22 As usual the ATO is driven by the possibility that the decision in Bamford might support some abuse and revenue loss. No matter that their interpretations lead to massive headaches for practitioners.

6.23 This much is exampled by several examples set out *in Practice Statement PS LA 2009/7* which was released prior to the decision in Bamford.

6.24 Examples 1 and 5 in particular show what the ATO is on about.

6.25 Example 1 concerns the trustee of a family trust deriving $250,000 in income during the income year and applying that income to the purchase of a holiday home. The trustee, acting in accordance with a power expressed in the terms of the Trust Deed to do so, determines that the expenditure on the purchase of the house is an outgoing on income account with the effect that the trust law income available for distribution is $5,000. One of the beneficiaries has tax losses.

6.26 The trustee distributes the $5,000 trust law income to the loss beneficiary. The losses cover the tax law income which follows the trust law income to the loss beneficiary.

6.27 The ATO expresses concern about the mismatch of the actual amount to which the beneficiary becomes entitled ($5,000) and the amount of the tax law income flowing to the beneficiary ($250,000) and the tax not paid because of the losses.

6.28 It is difficult to say why this is of concern to them. The true effect of the transaction is to maintain $245,000 in the capital of the trust. The same tax effect would be obtained by distributing all of the $250,000 to the loss beneficiary. There is no tax difference in this illustration. It is unlikely there would be a tax benefit for the purposes of Part IVA. The most likely explanation for the transaction is the financial risk the loss beneficiary has been exposed to. If the beneficiary became entitled to call on the trustee to pay him or her $250,000 the creditors may be able to stake a claim to that amount. It is a neat and sensible piece of asset protection planning.

6.29 Example 5 is about a trust which has distinct income and capital beneficiaries. The trustee has a power to determine whether receipts and outgoings are on income or capital account. The Trust Deed is amended to admit a tax exempt entity as a beneficiary.

6.30 The trust derives $100,000 of income (meaning income according to ordinary concepts) during the income year. The trustee determines that $95,000 of that amount is a capital receipt. The remaining $5,000 is the trust law income according to the Trust Deed. This amount is appointed to the tax exempt beneficiary. All of the tax law income will be assessed to the charity. It would follow that the trustee makes a capital distribution of the $95,000 to a family beneficiary.

6.31 The ATO observe in the Practice Statement that Part IVA might apply in the circumstances. In the writer's view it almost certainly would do so in particular because of the amendment to introduce the tax exempt charity as a beneficiary and the fact that prior year distributions had been made only to family members. A much more challenging (and perhaps more realistic) illustration would arise if the tax exempt charity was already an object and the trustee had made distributions to charities in the past. The Part IVA case in such circumstances would be difficult to make out. This is an example of the acknowledged "apparent unfairness in the resulting administration of the legislation" as noted by the High Court in Bamford at [17].

6.32 The ATO apparently accept that Bamford authorizes characterization of capital receipts as income for the purposes of the Deed but are not so ready to accept that ordinary income may be recharacterised as capital (as in Example 5). They appear to be fortified in this by observations made by the Full Court of the Federal Court in *Forrest v C of T* [2010] FCAFC 6 ("**Forrest**").

6.33 The relevant question before the Court there was whether Mr Forrest was entitled to a deduction for interest he had incurred in relation to funds he had borrowed to acquire units in a unit trust. The outcome turned on whether there was a fixed income component to which the funds related. The Full Court concluded that a power to determine whether any amount received by the trustee was on revenue account or capital account (clause 12 of the Deed) was not a power to change the beneficiaries' rights. In so doing they observed at [11]-[12]:

> *'In our opinion, the power conferred by cl. 12 cannot be exercised by the trustee wrongly to classify a receipt as a capital gain, when the receipt is, in truth, income, and thus deprive the appellant of his interest in the unit component of the trust. Clause 12 is not an unlimited power to be exercised in the trustee's unconfined discretion….*
>
> *Clause 12.2(a) is a power to determine how a distribution to beneficiaries is classified. That limited power is not a power which is capable of altering the beneficiaries' rights. Clause 12 is to be read consistently with the balance of the Trust Deed and an appreciation that it contains various powers of an administrative character. The words used can be given full force honestly to classify income or distributions according to law, as the appellant contended to this Court".*

6.34 It is very difficult to know how far this goes. The issue in Forrest was about whether or not the exercise of the power changed the rights as between classes of beneficiaries. Presumably the ATO would say that the exercise of the power in a case like that in Example 5 was not an "honest" classification of the receipt as capital. Hopefully the issue will not arise very often.

Point of Interest

6.35 A case of interest is *Greenhatch v FCT* [2011] AATA 479 that ostensibly concerned superannuation contributions where the answer to the superannuation question was determined by construing streaming through a trust. The case of is interest for two reasons.

6.36 First, the AAT went out of their way to note the Commissioner's interpretation of Bamford was wrong. At [49] and [50] they said:

> *Much, if not all, of the Commissioner's case turns on his rejection of any underlying conduit theory and his interpretation of the implications of the decision in Bamford.*

The Commissioner's contention that the conduit theory has no role to play is based on foundations with which we do not agree. Accordingly, those foundations do not support the conclusion he seeks to draw.

6.37 Secondly, in relation to Subdivision 207-B of the 1997 Act, being the franking credits provisions, the AAT observed at [63]:

> *Section 207-35 of the 1997 Act has an aspect that makes the conclusion [that] amounts passing through trusts to beneficiaries thereof carry the character and identity that they had in the hands of the trustee more compelling. That section includes an example that contemplates differential distributions in determining the taxation burdens that are imposed on the beneficiaries of the trust.*

6.38 Question: was it necessary to introduce the Streaming Amendments in light of the above comments? Given we have the Streaming Amendments it is of academic interest only.

Streaming Amendments

6.39 The *Tax Laws Amendment (2011 Measures No. 5) Act* 2011 (Cth) was introduced into parliament (as a Bill) on 2 June 2011, was passed unamended and assented to on 29 June 2011. They take effect from 1 July 2010. These dates show how close a call it was as the Streaming Amendments are critical for trustee decisions that were needed to be made on 30 June 2011 – one day after their royal assent.

6.40 Subject to a statement by the Commissioner – extending the time a trustee could make decisions to 31 August 2011, which has anyway passed, but the writers question the Commissioner's ability to alter what trust law[6] requires to be done on 30 June of any year – the Streaming Amendments apply to trustees resolving to deal with trust income and capital gains.

6.41 From the 2011 income year and thereafter taxable capital gains and franked distributions are dealt with under these rules.

6.42 The Streaming Amendments operate by diverting from Division 6 of the 1936 Act the franked distributions and taxable capital gains. They are assessed directly in the hands of the beneficiaries who are presently entitled to them. They do this via Subdivision 207-B of the 1997 Act for franked distributions and via Subdivision 115-C of the 1997 Act for taxable capital gains. However, for the taxable capital gains they must still pass through the method statement in s 102-5(1) of the 1997 Act.

[6] *Trustees of the Estate Mortgage Fighting Fund Trust v FCT* [2000] FCA 981 per Hill J; *Case R105,* 84 ATC 692; *Antonopoulos v FCT* [2011] AATA 431.

6.43 The Streaming Amendments have introduced a new Division 6E into Part III of the 1936 Act to prevent double taxation. It adjusts the Division 6 income and net income of the trust to take out the amounts to which the beneficiary has been made specifically entitled.

6.44 It can be seen that the specific entitlement of the beneficiary or beneficiaries is the critical aspect of the Streaming Amendments. This is required to determine tax liability.

Specific Entitlement

6.45 The notion of a specific entitlement conceals the difficulties of applying the Streaming Amendments to all trusts, be they discretionary, fixed, unit, et cetera. The mechanism by which you become specifically entitled are set out in the relevant Subdivisions: s 115-228 for capital gains and s 207-58 for franked distributions. The provisions seem substantially similar at first look but there are some significant differences.

6.46 A beneficiary is specifically entitled under s 207-58 of the 1997 Act to an amount of a franked distribution made by the trust equal to the amount calculated under the following formula

$$\text{Franked Distribution} \times \frac{\text{Share of net financial benefit}}{\text{Net financial benefit}}$$

6.47 The "net financial benefit" is an amount equal to the financial benefit referable to the franked distribution (after an application by the trustee of expenses that are directly relevant to the franked distribution).

6.48 The term "financial benefit" is already in s 995-1 f the 1997 Act. It means anything of economic value, even if the transaction also imposes an obligation on the entity. Benefits and obligations are to be looked at separately and not set off against each other, but it is the net financial benefit to which the formula looks.

6.49 The "share of the financial benefit" is the amount of the financial benefit referable to the franked distribution specifically linked to the particular beneficiary. The share of the net financial benefit is:

> *… an amount equal to the *financial benefit that, in accordance with the terms of the trust:*
>
> *a. the beneficiary has received, or can be reasonably expected to receive, and*
>
> *b. is referable to the *franked distribution (after application by the trustee of any expenses that are directly relevant to the franked distribution) and*
>
> *c. is recorded, in its character as referable to the franked distribution, in the accounts or records of the trust no later than the end of the income year.*

6.50 Section 115-228 is identical to the discussion above of franked distributions, subject to:

6.50.1 the financial benefit must be referable to the capital gain "after application by the trustee of any losses, to the extent that the application is consistent with the application of capital losses against the capital gain in accordance with the method statement in subsection 102-5(1)"; and

6.50.2 the recording of the financial benefit must be "no later than 2 months after the end of the income year."

Complexities and Going Forward

6.51 An issue to be mindful of is – in fact an issue of significant importance – is that a trust with no "income", which was one of the problems in the Bamford appeals, will not be able to stream franking credits. This will mean that where the franked distributions, together with other ordinary income, is insufficient to more than offset expenses of the trust the franking credits cannot go through to the beneficiaries. The same restriction does not apply in relation to capital gains streamed through the trust.

6.52 Ken Schurgott FTIA, in his paper in the August 2011 *Taxation in Australia* titled "Trust streaming 2011" notes a number of complications that arise from the Streaming Amendments:

> *As will be seen, there are a number of issues which emerge that complicate the legislation over and beyond the rather simple approach adopted prior to the Commissioner's stance on streaming. The things which complicate matters are:*
>
> *a. There can be different outcomes according to the definition of income adopted by the trust deed;*
>
> *b. Significantly different outcomes can result where a beneficiary has not been made specifically entitled to the franked distribution or capital gain. This is most pronounced in relation to capital gains;*
>
> *c. The concept of making a beneficiary entitled to the entire financial benefit from a capital gain or franked distribution is fraught with difficulty, particularly where there are capital losses or directly related expenses; and*
>
> *d. The way in which capital losses and directly related expenses are to be dealt with is confusing.*

6.53 It can be seen from these further issues, and the problem of actually apply what is a simple concept of diverting the amounts to Subdivisions 115-C and 207-B respectively, are anything but straightforward or settled. Indeed, a senior council on the writer's floor, after having advised on

the Streaming Amendments is of the view that this is where future archeologists will find the bones of 21st Century tax lawyers and accountants.

7. Changes to the taxation of trusts – terms to be provided for in a trust document

7.1 Given the changes in the taxation of trusts, it is recommended that trust deed (or any other constituent documents) be reviewed so as to determine:

7.1.1 How income, capital gains and outgoings are accounted for and determined; and

7.1.2 How income, capital gains and outgoings are to be distributed.

7.2 Some of the powers which may be advantageous to have within a trust instrument include:

7.2.1 an accounting policy which is sufficiently broad and allows the trustee to exercise maximum discretion;

7.2.2 the discretion to reclassify and allocate income and capital gains;

7.2.3 the discretion to reclassify and allocate outgoings;

7.2.4 the discretion not to recoup losses (whether income or capital in nature);

7.2.5 the ability to allocate and stream classes of income and capital and their related tax attributes;

7.2.6 and ensure that any unpaid present entitlement / loan provisions are removed, and an ability to hold amounts subject to a sub-trust.

7.3 Some additional powers to be considered include:

7.3.1 whether the trustee has the power to distribute income and / or capital at any time within a tax year;

7.3.2 whether any determination of income (or capital) can be made within the income tax year; and

7.3.3 whether the trustee has a power to determine entitlements with respect to an income tax year after the relevant year.

Accounting policy

7.4 Essential is ensuring that the trust deed provides guidance with respect to an accounting policy that should be used by the trustee. Such an accounting policy should provide sufficient flexibility for the trustee, so that it may depart from generally accepted accounting standards in the event that the trustee considers that it is appropriate to do so.

Reclassifying and allocating income and capital

7.5 As the High Court in *Bamford* accepted that the tax law income of a trust is dependent upon (amongst other things) the definition of that term in the trust deed, regard should be given to the definition of the 'income' as contained in the trusts constituent documents.

7.6 An issue to consider is whether attributed amounts (e.g. franking credits) should be included within the definition of trust income. An issue that arises is that if attributions are included in trust income (and which are not physically 'paid' by a trustee – but which follow certain amounts of income), whether by being included in trust income, and thereby providing that a trustee creates a 'present entitlement' in a beneficiary to an amount that is never received by a trustee, the trustee will be exposed to a claim in relation to amounts that are not actually received by the trustee.

7.7 It is submitted that amounts such as franking credits should be prima facie carved-out of the definition of income. However, the definition should contain discretionary elements to allow a trustee to cause such 'attributed' amounts to fall within the definition of income.

7.8 An approach which may be considered is, in defining trust income:

7.8.1 Provide that it prima facie equals the amount provided for in s 95(1) of the 1936 Act (less any franking credits);

7.8.2 If the tax law approach is not warranted for a particular tax period, then:

7.8.2.1 According to an accounting policy adopted by the trustee; or

7.8.2.2 Any other basis as determined by the trustee; or

7.8.3 In the trustee's absolute discretion, the gross income of the trust.

Reclassifying and allocating outgoings

7.9 In *Cajkusic v FC of T (No 2)* (2006) ATC 4752 ("**Cajkusic**") deductions allowable to a family discretionary trust for payments that were made under an employee benefits trust arrangement in the income tax years ending 30 June 1997 and 30 June 2008 caused there to be a loss within the trust estate.

7.10 As a result of the losses, there was no distributable income of the trust. As a result, the Full Court of the Federal Court held that the lack of distributable income meant that there could be no beneficiary of the trust (for the relevant income tax years) to be "*… presently entitled …*'"pursuant to s 97 of the 1936 Act to any amount.

7.11 It should be noted that the Commissioner's subsequent application for special leave to appeal to the High Court was rejected.

7.12 Cajkusic stands for the proposition that the 'distributable income' of a trust is determined by reference to proper accounting principles, as well as the terms of a trust deed. In this context distributable income is income determined according to accounting principles, and which is distributable amongst the beneficiaries. It does not alter either the income as calculated under accounting principles, of the 'net income' as determined under s 95(1) of the 1936 Act – rather, only gives a trustee the power to determine the distributable amounts.

7.13 As a result of the decision in Cajkusic, it is submitted that a trust deed should give a trustee the power to reclassify, and allocate outgoings, so that there can be 'distributable income' to which beneficiaries are presently entitled.

Discretion not to recoup losses (whether income or capital in nature)

7.14 It is recommended that a trustee have a discretion not to recoup losses (whether of an income or capital nature). That is, a power not to recoup losses which have arisen in the past.

8. Resettlement considerations

8.1 Whenever the terms of a trust are varied, an issue to consider is whether the variation amounts to a 'resettlement'.

8.2 Resettlements relate to changes to a trust relationship which have the effect that a new trust estate comes into existence. According to the High Court in *FC of T v Commercial Nominees of Australia Ltd* [2001] HCA 33 (***"*Commercial Nominees"**), the issue to determine is whether '*… what occurred* … [i.e. the variation] … *was a fundamental alteration in the trust relationship*

established by the original deed, such that it destroyed the necessary continuity of the 'taxpayer'…'.

8.3 A resettlement can have significant income tax, capital gains tax (**'CGT'**) and stamp duty consequences, including that:

8.3.1 the trust property may be disposed of, potentially triggering both stamp duty and CGT liabilities;

8.3.2 carried forward tax benefits may be lost; and

8.3.3 beneficiaries may dispose of their interests in the original trust and acquire interest in a new trust.

8.4 Specifically in the context of CGT, a resettlement may cause either CGT event E1 (s 104-60 of the 1997 Act) or CGT event E2 (s 104-65 of the 1997 Act) to happen.

8.5 In August 2001 the issued a Statement of Principles entitled *Creation of a new trust* (the **"Statement**"). The Statement clarifies when, in the Commissioner's view, changes to a trust gives rise to a new trust. The Commissioner considers that a new trust estate arises where there is a 'fundamental change to a trust relationship' – ie, a change in the essential nature and character of the original trust relationship. Further, the Commissioner considers that a new trust (i.e. a resettlement) may arise in the following circumstances:

- a change in beneficial interest in trust property;
- a new class of beneficial interest (whether introduced or altered);
- a redefinition of the beneficiary class;
- changes in the terms of the trust or the rights or obligations of the trustee;
- changes in the nature of the trust property;
- additions of property which could amount to a new and separate settlement;
- depletion of trust property;
- a change in the termination date of the trust;
- a change in the trust that is not contemplated by the terms of the original trust;

- a change in the essential nature and purpose of the trust; and / or
- a merger of two or more trusts or a splitting of the trust.

8.6 The Commissioner considers that depending on their nature and extent, the above changes may either amount to:

8.6.1 a variation of a continuing trust; or

8.6.2 a fundamental change in the essential nature and character of the trust relationship. In such a case, the original trust may be brought to an end and a new trust created. Whether a new trust is created depends on the terms of the original trust and on the powers of the trustee.

8.7 The High Court in Commercial Nominees held that significant changes to a superannuation fund trust deed did not create a new trust, even though the amending deed had:

8.7.1 changed the name of, and appointed a new trustee to the fund;

8.7.2 introduced a new category of beneficiaries;

8.7.3 changed the fund from a defined benefit fund to an accumulation fund;

8.7.4 appointed a professional management company as administrator; and

8.7.5 allowed membership to be promoted to the public.

8.8 The High Court in *Commercial Nominees* considered that there were three main indicators of the continuity of a trust relationship, being:

8.8.1 the constitution of the trust;

8.8.2 the trust property; and

8.8.3 the membership of the trust.

8.9 Substantial changes any of the above may cause a resettlement.

8.10 The High Court considered that, in order to destroy the necessary continuity, changes in one or more of the above indicators must be such as to terminate the existence of the entity, or to produce the result that the particular trust does not derive the income in question. It was held that the changes made to the trust deed in question were not sufficient to destroy the continuity, primarily because the fund was at all times governed by the same deed, the trust property did not change, and the members before the amendment to the trust deed remained members afterwards. We consider that the amendments discussed above will not cause a resettlement.

8.11 The Commissioner notes in the Statement that administrative changes, such as re-defining trust income (without more) may not cause a resettlement (depending on the context) as it may be administrative in nature.

8.12 However, regard will need to be given to the implications to the membership (i.e. the beneficial entitlements) of the trust, and what implications such an amendment will have on the respective entitlements in a trust. For example, an important consideration will be determining how unallocated / undistributed income is to be dealt with. For example, is such income:

8.12.1 accumulated, and form part of the corpus of the relevant trust estate;

8.12.2 is it distributed to certain default beneficiaries; or

8.12.3 is it held on trust for a specific purpose (e.g. a charitable purpose).