STEP (WA)

TRUST CONFERENCE

18 OCTOBER 2019

DISCRETIONARY TRUST TAXATION

Introduction

The focus of this paper is income tax and discretionary trusts.

I won't be examining the taxation of special categories of discretionary trust such as special disability trusts, testamentary trusts,[1] child maintenance trusts, estate proceeds trusts, compensation trusts or insurance trusts. I also won't be dealing with the taxation of foreign trusts.

When I refer to legislation, it is to the *Income Tax Assessment Act 1936* and *Income Tax Assessment Act 1997* (**ITAA**), unless otherwise stated.

Background

In 2015-16, the ATO recorded that there were 845,925 trusts in Australia, with assets exceeding $3 trillion, generating annual income of at least $340 billion (or ~$400,000 per trust). Over 625,000 of those trusts were discretionary trusts. In 2016-17, the number of trusts increased to 874,874.[2] It has been predicted that there could be more than a million trusts in Australia by 2022.[3]

We have an untidy regime of general trust taxation rules. Australia's laws on taxing trusts date back to the *Income Tax Assessment Act 1922*.[4] The taxation of trusts is a complicated area having regard to the fact that there are layers of taxation concepts that we have to grapple with as a result of piecemeal and reactive legislative changes to perceived exploitations from time to time over nearly 100 years. The ATO has also been on the front foot with public rulings and determinations, which are often controversial and not always in line with court decisions.

The tax rules affecting discretionary trusts have been layered on like fresh coats of paint in a patch up fashion over the top of old, flaking and peeling layers. I'm going to peel back and

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[1] In the course of writing this paper, Treasury released a draft Bill, on 3 October 2019, seeking comments and submissions by 30 October 2019, to implement a measure announced in the 2018-19 Federal Budget to preclude the tax concessions for minor beneficiaries in relation to income from a testamentary trust under Div 6AA of the ITAA where assets unrelated to the deceased estate are injected into such a trust. If enacted, the new law will limit the concessional 'excepted trust income' treatment to income from assets transferred to the trustee from the deceased estate or from the accumulation of such income.

[2] https://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Taxation-statistics/Taxation-statistics-2016-17/?anchor=Trusts#Trusts

[3] See De Silva, A, Glover, J, Narayanan, V, Nguyen, T and Westberg, K 2018, *Current issues with trusts and the tax system*, ATO, Australia

[4] Section 31 of the *Income Tax Assessment Act 1922* provided a similar regime for taxing trust income as ss.97, 98 and 99 of Div 6 of the ITAA.

probe through some of the more recent layers with you, to reveal the core concepts and issues currently in play and expose gaps and shortcomings that are still crying out to be fixed.

I don't have time to take you back over the last century of trust taxation. What I will do is reflect on some of the biggest developments affecting discretionary trust taxation over the last decade. I'm going to keep it practical where I can with real life examples and hypothetical case studies. This is what I plan to cover:

1. The Div 6 regime exposed: *Bamford*
2. *Greenhatch* and the streaming provisions
3. Unfair outcomes and opportunities post-*Bamford* and streaming amendments
4. The shifting sands of trust resettlement
5. Trust splitting and the ATO's contentious *TD 2018/D3*
6. Trust Vesting, the *Hancock v Rinehart* case and *TR 2018/6*
7. Reform proposals

Div 6 exposed

A trust is not a separate legal entity and Div 6 does not treat a trust as a taxable entity. Div 6 allocates liability for tax on the net income of a trust estate by assessing either the trustee or one or more beneficiaries. Div 6 assumes that the person who benefits from the income of the trust estate should be the one to pay the tax. Division 6 relies heavily on concepts like present entitlement and legal disability to determine how the income derived through a trust structure is taxed, who is taxed and the applicable tax rate. A person's residency can also affect the tax outcome.

Div 6 operates by identifying the distributable "income" and the taxable "net income" of a trust estate and then assesses either the trustee or the beneficiary (and sometimes both) on "shares" of the net income. Beneficiaries are generally taxed on their share of the net income (if they are presently entitled to a share of the income), unless they are under a legal disability. They are also taxed on amounts distributed to them or applied for their benefit which represent previously untaxed income.

Div 6 operates to tax:

- the presently entitled beneficiary not under a legal disability on the net income of the trust at marginal or corporate tax rates;
- the trustee on behalf of the presently entitled beneficiary under a legal disability on the net income of the trust at marginal tax rates; and
- the trustee at top marginal rate on the net income of the trust to which no beneficiary is presently entitled.

The main gateway provision in Div.6 is s.97(1)(a), which states:

> *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****, 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*
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> *(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.*

In this provision there is a critical distinction between income of the trust estate, which is also called 'distributable income', and net income of the trust estate, also known as s.95 net income or taxable income. Often the two are not the same. Why not?

Believe it or not, s.95 net income (taxable income) is the more definitive of the two. Section 95 defines "**net income**" in relation to a trust estate to mean:

> *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 (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 in respect of such of the tax losses of previous years as are required to be met out of corpus. A trust may be required to work out its net income in a special way by Division 266 or 267 in Schedule 2F to this Act or Division 275.*

Just because "net income" is defined doesn't mean that it is always easy to work out. Assessable income includes both ordinary income and statutory income. In relation to ordinary income, the following classical sources might come to mind: interest earned on a bank account or loan to another person or entity, rent received on a leased property, dividends received from shares, income received from carrying on a business.[5] Statutory income includes a range of other types of receipts, which don't fall within the category of ordinary income and are only assessable because the ITAA deems them to be so. Notably, this includes net capital gains, franking credits attaching to franked dividends, as well as certain lump sum payments received on termination of employment, royalties, insurance bonuses, bad debts recovered, barter transaction benefits, various assessable recoupments, plus a range of many other things.[6]

To work out taxable income, you need to deduct various expenses, outgoings and losses from the assessable income. There are both general deductions and specific deductions.

General deductions are losses or outgoings that are incurred in gaining or producing your assessable income, or necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income, and are deductible under s.8-1.[7] This includes, for example, fees and charges for earning bank interest, dividends or investment income, interest on money borrowed for your business or to acquire income producing assets, rent and outgoings paid on business premises or premises that are sub-let to another person for rent, business operating expenses such as advertising costs, salaries, wages and employee benefits, insurance premiums, cost of professional services such as legal and accounting fees, telephone, internet and utility charges and office supplies, to name a few.

Specific deductions are allowed for amounts incurred that don't qualify for a general deduction under s.8-1 but are deductible under another specific provision of the ITAA. Examples include capital allowances (depreciation), gifts to DGRs, among many others. Certain categories of expenditure are specifically denied, reduced or deferred deductibility, e.g. certain entertainment expenses, boating expenses, bad debts, pre-paid expenses, car parking, fines and penalties.[8]

When working out taxable income, sometimes there are arguments and disputes about whether something is assessible or deductible or included in cost base or in the calculation of a capital gain or other statutory income, or whether something is exempt or non-assessable. Sometimes the ATO will review what has been claimed or declared in a tax return and will amend an assessment. In that case, there may even be a dispute about who should be

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[5] See s.6-5.

[6] See s.10-5, which contains a table with an extensive list of sections of the ITAA that include statutory income in assessable income.

[7] See s.8-1.

[8] See s.12-5, which contains a table with an extensive list of sections of the ITAA that allow a statutory deduction. Section 26-5 specifically makes penalties or fines imposed as a result of breaches of an Australian law non-deductible.

assessed on the extra taxable income – should it be the trustee, or the beneficiaries, and if the latter, which beneficiaries?

What then is distributable income? The concept of "income of the trust estate" is not defined. There has been debate about what the phrase "income of the trust estate" means. Does it mean trust accounting income, or ordinary income, or trust income, and to what extent can it be affected by the terms of the trust deed and the discretion of the trustee exercising powers under the trust deed? Until quite recently, there was no case law clarifying what it meant. The ATO view is that it should be limited to income according to ordinary concepts and trust law. Recent case law has confirmed that the terms of the instrument creating the trust can affect what is or is not included in distributable "income of the trust estate".

There has also been a great deal of uncertainty and debate about which approach should apply to determine who should be assessed and in which amounts where the two are not equal, and who should be assessed and in which amounts in cases where there is no distributable income, or where the distributable income is eaten up by expenses or losses.

While practitioners have been aware of these issues since at least 1978,[9] clear judicial authority addressing these issues arrived only fairly recently. This paper discusses the landmark High Court decision of *Bamford*[10] in some detail below.

The rate of tax applying to the net income of a trust under Div 6 depends on who is assessed and the assessing provision including whether an anti-avoidance rule applies.

Div 6 assesses a beneficiary who is "presently entitled" to a share of the income of a trust estate (i.e. trust income) and is not under a legal disability.[11]

As a result of this provision, a discretionary trust provides the perfect structure to minimise the overall impost of income tax on the income derived from the trust property. The trustee can control who pays tax on the income by exercising their discretion to determine which beneficiaries are presently entitled to the income and in which amounts and proportions.

Splitting trust income between the lowest tax rate beneficiaries can result in the lowest impost of tax on that income and can generate significant tax savings, depending on the tax profile of the beneficiaries. This is one of the reasons why discretionary trusts are so prolific. The other big reason is asset protection.

However, there is a major tax drawback under Div 6, a big tax disincentive against the trustee retaining profits, accumulating income. Where there is income to which no beneficiary is presently entitled, the trustee is assessed at top marginal rate under s.99A (currently 45%) plus Medicare levy (currently 2%), except in the limited circumstances where s.99 operates.[12]

Subsections 99A(4)-(4C) are reproduced below:

> *(4) Where there is no part of the net income of a resident trust estate:*

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[9] Grbich, Y, Munn, G & Reicher, H. (1978) *Modern trusts and taxation*, Commercial Law in Context Series; Leibler, M. "Distributions of trust income – some selected problems" in (1979) Tax essays, vol 1, Butterworths, Sydney.

[10] *FCT v Bamford* [2010] HCA 10

[11] See s.97.

[12] The Commissioner's discretion extends s.99 to trusts resulting from the will or intestacy of a deceased person, trusts of property vested in the official receiver in bankruptcy or being administered under Part XI of the *Bankruptcy Act 1966*, and trusts consisting of property transferred to the trustee for the benefit of a beneficiary as a result of a family breakdown, or by way of satisfaction of a claim for damages for loss of parental support, personal injury, disease, or physical or mental impairment, or workers or criminal injury compensation, or proceeds of a life assurance policy or as a death benefit from a superannuation fund or employer of the deceased person, or out of a public fund established and maintained exclusively for the relief of persons in necessitous circumstances.

(a) that is included in the assessable income of a beneficiary of the trust estate in pursuance of section 97;

(b) in respect of which the trustee of the trust estate is assessed and liable to pay tax in pursuance of section 98; or

(c) that represents income to which a beneficiary is presently entitled that is attributable to a period when the beneficiary was not a resident and is also attributable to sources out of Australia;

the trustee shall be assessed and is liable to pay tax on the net income of the trust estate at the rate declared by the Parliament for the purposes of this section.

(4A) Where there is a part of the net income of a resident trust estate:

(a) that is not included in the assessable income of a beneficiary of the trust estate in pursuance of section 97;

(b) in respect of which the trustee is not assessed and is not liable to pay tax in pursuance of section 98; and

(c) that does not represent income to which a beneficiary is presently entitled that is attributable to a period when the beneficiary was not a resident and is also attributable to sources out of Australia;

the trustee shall be assessed and is liable to pay tax on that part of the net income of the trust estate at the rate declared by the Parliament for the purposes of this section.

(4B) Where there is no part of the net income of a trust estate that is not a resident trust estate:

(a) that is included in the assessable income of a beneficiary of the trust estate in pursuance of section 97;

(b) in respect of which the trustee of the trust estate is assessed and liable to pay tax in pursuance of section 98; or

(c) that is attributable to sources out of Australia;

the trustee shall be assessed and is liable to pay tax on the net income of the trust estate at the rate declared by the Parliament for the purposes of this section.

(4C) Where there is a part of the net income of a trust estate that is not a resident trust estate:

(a) that is attributable to sources in Australia;

(b) that is not included in the assessable income of a beneficiary of the trust estate in pursuance of section 97; and

(c) in respect of which the trustee of the trust estate is not assessed and is not liable to pay tax in pursuance of section 98;

the trustee shall be assessed and is liable to pay tax on that part of the net income of the trust estate at the rate declared by the Parliament for the purposes of this section.

Note: If the trust estate's net income includes a net capital gain, Subdivision 115-C affects the assessment of the trustee.

Section 99A is what you might describe as a sledge hammer to crack a walnut. On top of top marginal rate taxation, if the assessable income is a capital gain, the trustee cannot benefit from the CGT 50% general discount or the CGT 50% small business reduction where s.99A applies.

Section 99A has not been a feature of Div 6 from the beginning. It was inserted into the ITAA in 1964 as a measure to counter tax avoidance following the Ligertwood Committee report on taxation in relation to tax avoidance.[13] The Committee noted:[14]

> *710. We are informed that increasingly in recent years, there has been a loss of revenue arising from the deliberate use of trusts as a tax-avoiding device. The amount settled under a trust may be a purely nominal amount, but this is of little consequence as it does not stop the settlements from acquiring substantial assets. The assets may be bought on a small deposit with the balance to be paid out of future income. The vendor is generally the parent of the children whose favour the settlements were created, and he is appointed trustee. Thus, a father could sell his business to a partnership consisting of the several trusts created. The income of the business, formerly assessed to the parent, would thereupon become split several ways and assessed to the trustee at much lower rates of tax. As trustee, the parent would retain control of the business…*
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> *711. [I]n the interests of the Revenue and of taxpayers generally, remedial action should be taken. The objective should be to assess family trusts of the type now under discussion at a rate designed to result in payment of a tax equal to that which would have been pay-able if the person originally in receipt of the trust income, had continued to receive it."*

The Explanatory Memorandum to the relevant Bill stated:[15]

> *Where the present section 99 applies in relation to income, the trustee is taxed on the income as if it were the income of an individual. If the net income of a year of income is Pd208 or less, therefore, the trustee is not liable to tax. Where it is Pd209 or more, tax is payable by the trustee at the appropriate rate prescribed for an individual taxpayer. When income to which section 99 applies eventually reaches a beneficiary, it is not taxed in the hands of the beneficiary.*
>
> *The proposed new section 99 will operate in the same way as the section it replaces. The proposed section 99A will, however, apply in relation to some trust estates to which section 99 would otherwise apply. Where section 99A applies, it is proposed that tax at the flat rate of 10s. in the Pd1 will be imposed on income being accumulated in the trust, irrespective of the amount of the income of the year of income.*[16]

The Treasurer's Second Reading Speech to the House of Representatives recommending the Bill introducing s.99A stated:

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[13] Inserted by s.25 of *Income Tax and Social Services Contribution Assessment (No. 3)* – Act No 110 of 1964, assented to 23 November 1964.

[14] (1961) Parl. Pap. No. 100, paras 710, 711. See also Sappideen, R. *'Sections 99 and 99A of the Income Tax Assessment Act 1936: Their Past and Present Roles, and a Suggested Future Role'* [1978] NSWLJ 267.

[15] *Explanatory Memorandum to the Income Tax and Social Services Contribution Assessment Bill (No. 3) 1964*, clause 25, circulated by authority of then Treasurer, the Rt. Hon. Harold Holt.

[16] It may be noted that 10s. in the Pd1 was also the same rate of tax as imposed on the undistributed profits of private companies in 1963 following the Ligertwood Committee's report. Keep in mind that before decimal currency in Australia, there were 20 shillings to the pound – so 10s. in the Pd1 meant a tax rate of 50%. Also bear in mind that prior to 1 July 1986, the top marginal rate was 60%. In 1985-86, that top rate of tax applied to taxable income of $35,000 and over. During the Menzies years of 1954-55 and 1964-65 the top personal tax rate was 66.67 per cent. See e.g. Grudnoff, M. & Richardson, D. (2018) *Personal income tax cuts – discussion paper*, The Australia Institute.

> *The Government is quite conscious, however, that it is not the purpose of all such trusts to avoid tax that would otherwise be payable. For this reason, the legislation will oblige the Commissioner to consider all relevant facts and authorise him not to apply the new provisions where it would be unreasonable to do so. The legislation will state various specific matters that the Commissioner must consider for this purpose.*

This measure ultimately led to top marginal rate taxation applying to accumulated profits for virtually all discretionary trusts.

It is understandable that the government wanted to put a stop to people using partnerships of multiple trusts to minimise tax by exploiting s.99. The fact that accumulated income formed part of corpus and so could be distributed tax-free to beneficiaries in a later year also contributed to the loss of revenue.

The centrepiece of the Ligertwood Committee's solution to tackle trust tax avoidance was actually a proposed amendment to s.102, which affects revocable trusts. The Committee wanted to extend s.102 so that it applied where distributions were made to minor relatives, not just minor children, and to aggregate multiple trusts together. People were setting up partnerships of multiple trusts at the time to take advantage of the tax-free threshold and lower marginal tax rates under s.99, as it taxed each trustee as a separate individual. Unfortunately the government never acted on the s.102 recommendation. They rested solely on s.99A.

Whatever the justification back in 1964 for taxing trustees at 50% on accumulated income, those reasons arguably no longer apply. Indeed, since 1964, our laws have come a long way to provide concessions for small business, including those who use discretionary trusts. We now have a specific anti-avoidance regime to target the alienation of personal services income (APSI), which were enacted in 2000.[17] While the corporate tax rate fell to 30%, and for certain 'small business' companies to 27.5%, the rate of tax on undistributed trust profits did not.

As a result of the now punitive rate of tax on trustees that accumulate income, retaining profits is almost unheard of with discretionary trusts. If retained profits were instead taxed at a flat corporate rate of say 30%, that might eliminate much of the manipulation, exploitation and tax planning activity that we have seen around discretionary trusts, including the rise of bucket companies, which are taxed at 30%, and the government's response by continuing to expand and strengthen the operation of Division 7A, using a combination legislative amendments and ATO rulings and intervention. If trustees were taxed at 30% on undistributed income, there is no reason why we also couldn't tax the beneficiary, at their applicable tax rate, when the after-tax profit is distributed to them, subject to allowing a credit for the tax paid by the trustee (similar to the integrated manner in which Australia taxes corporate profits and dividends), rather than treating such amounts as we currently do, as a tax-free distribution of corpus.

There are 4 scenarios where the trustee may be assessed in its capacity as trustee:

1. Where there is income in respect of which no beneficiary is presently entitled. This can occur by design, e.g. in rare cases where the trustee effectively resolves to accumulate income, or inadvertently, where the trustee fails to cause beneficiaries to become presently entitled to trust income or specifically entitled to capital gains and franked distributions, where there are no default beneficiaries. Section 99 or 99A will apply. If 99A applies, the trustee will be assessed at top marginal rate.
2. Where a non-resident beneficiary is presently entitled to an Australian source of income of the trust. In that case, s.98(3) will apply to assess the trustee at non-resident tax rates. The non-resident beneficiary is also assessed, however obtains a credit for the tax paid by the trustee.

[17] *New Business Tax System (Alienation of Personal Services Income) Act 2000*

3. Where a beneficiary under a legal disability (e.g. a minor) is presently entitled to income of the trust estate. In that case, the trustee is assessed and pays tax at the beneficiary's rate of tax: s.98(1)
4. Where the trustee of a resident trust elects to be assessed on a capital gain – this is allowed where it is permitted by the trust deed and only if no beneficiary has received any amount referable to the gain during the income year or within two months of the end of the income year. The trustee election must be made in respect of the whole capital gain within 2 months of the end of the income year or a later date if the ATO allows it. If the trustee makes this election, the trustee will be assessed on the capital gain under s.99 or s.99A as appropriate.[18]

In relation to point 4 above, it is unclear why a trustee would ever choose to be assessed on a capital gain where s.99A applies. The CGT 50% discount and the CGT small business 50% reduction are unavailable where s.99A taxation applies, however those concessions are still available where the trustee is assessed under s.99. Section 99 only applies to limited categories of trust, including notably trust estates resulting from a will or codicil.

The ATO suggests that a trustee might choose to pay tax on a capital gain where, for example, tax on the capital gain would otherwise be paid by:

- an income beneficiary who can't benefit from the gain because the gain is capital under the terms of the trust; or
- a capital beneficiary who is unable to benefit from the gain during the income year in which it is made, or within two months of the end of that year.

Section 100A is a specific anti-avoidance provision under Div 6. To the extent that a beneficiary's entitlement arises out of a reimbursement agreement, s.100A disregards it, meaning that the net income that would otherwise have been assessed to the beneficiary (or trustee on their behalf) is instead assessed to the trustee at the top marginal tax rate.

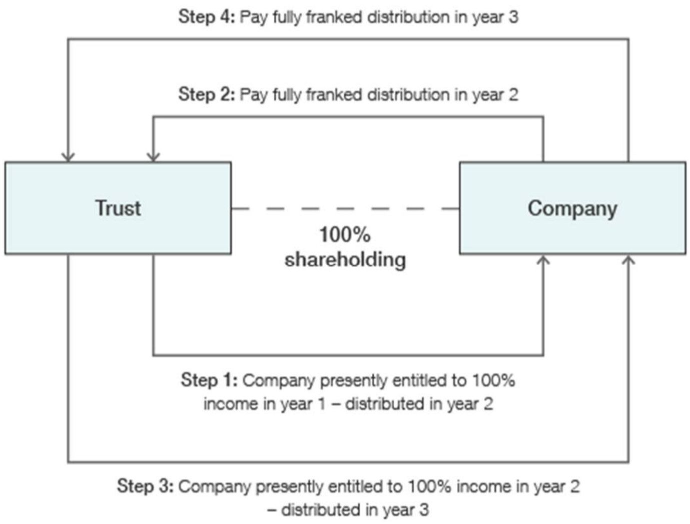
The ATO has an unlimited period within which to make an assessment under s.100A. The following scenario involving the use of a corporate beneficiary provides an example of where the ATO has said that it would apply s.100A on the basis that it constitutes a reimbursement agreement:[19]

1. The trustee of a trust owns all of the shares in a private company. The company is also a beneficiary of the trust and undertakes no activity, but derives a small amount of bank interest on its own account.
2. The directors of the trustee company and the beneficiary company are the same (or related) individuals.
3. The trustee resolves to make the company presently entitled to all, or some part of, trust income at the end of year 1, and distributes it to the company in year 2 before the company lodges its year 1 income tax return.
4. The company includes its share of the trust's net income in its assessable income for year 1 and pays tax at the corporate rate. (Division 7A does not apply because the company's entitlement is paid before it lodges its income tax return for the year in which the entitlement arose.)
5. The company pays a fully franked dividend to the trustee in year 2, sourced from the trust income, and the dividend forms part of the trust income and net income in year 2.

[18] See s.115-230.

[19] Distributing to a corporate beneficiary the shares in which are owned by the trustee of a trust would not of itself trigger s.100A. However, in this scenario (colloquially described as a 'washing machine') the offensive aspect is the step of recirculating the dividend back into the trust each year in order to effectively retain the income in the trust without incurring (perpetually deferring) any additional tax.

6. The trustee makes the company presently entitled to all, or some part of, the trust income at the end of year 2 (possibly including the franked distribution). The arrangement is repeated.



Present Entitlement

This key concept is not defined in the legislation. It is based on trust law principles. At general law, a beneficiary is presently entitled to a share of the income of the trust estate if the beneficiary has both:

(a) an interest in the income which is both vested in interest and vested in possession (i.e. a "vested and indefeasible interest"); and
(b) a present legal right to demand and receive payment of the income, regardless of whether the precise entitlement can be ascertained before the end of the relevant income year and regardless of whether the income is available for immediate payment:

S 95A(2) deems a beneficiary to be presently entitled if the first condition only is satisfied.[20]

An application or dealing with income on behalf of or at the direction of the beneficiary is consistent with the beneficiary having a present entitlement. For example, if the trustee applies an amount of trust income in settlement of an amount owed by the beneficiary who is presently entitled to that income, the beneficiary remains presently entitled to the income even though they cannot receive it in cash.

A beneficiary who is under a legal disability can still be presently entitled, provided they could have demanded immediate payment of the income but for the legal disability.[21] For example, a 2-year old beneficiary may have an interest in possession in an amount of income that is legally ready for distribution, so that they have a right to obtain payment apart from the fact that they are under a legal disability.[22] Note that a minor to whom money is paid by a trustee is deemed to be presently entitled under s 101, although the trustee is assessed under s 98.

The phrase "vested and indefeasible interest" appears in s 95A(2) but is not defined in Div 6. The courts have said that, for Div 6 purposes:

1. an interest is "vested" if the beneficiary has an immediate fixed right of present or future enjoyment; and

[20] It may be noted that the deemed present entitlement provisions in s.96B and 96C of ITAA (which could deem a beneficiary holding an interest in a non-resident trust, including a contingent interest, to be presently entitled to a relevant share of the income of the trust) was repealed by *Tax Laws Amendment (Foreign Source Income Deferral) Act (No. 1) 2010* with effect from 14 July 2010.
[21] *FCT v Harmer* (1990) 24 FCR 237; 21 ATR 623
[22] *Trustees of the ID Taylor Trust v FCT* (1970) 119 CLR 444

2. an interest is "indefeasible" if it is not subject to any condition.

In practice, these concepts can be difficult to apply in unusual situations, and the inability to substantiate the "present entitlement" of a beneficiary will result in the trustee being assessed under s 99 or 99A.

Note that present entitlement must arise at the latest by the end of the income year. In *BRK (Bris) Pty Ltd v FCT*,[23] a trust deed contained a power to accumulate and then apply the income not accumulated in any income year to default beneficiaries. It was held that the present entitlement of the default beneficiaries did not arise until after the income year had expired. Consequently, the trustee was assessed under s 99A.

In the case of a discretionary trust, the generally accepted view is that a beneficiary only becomes presently entitled to trust income when the trustee exercises the discretion to make a distribution to that beneficiary in accordance with the trust deed. If an appointment of income is invalid and the income is not accumulated in the trust, the default beneficiaries (if any) will become presently entitled to that income. This underlines the importance of the trust deed and the wording of the distribution resolutions.

Beneficiaries can have a present entitlement to trust income even if they have no knowledge of it. A beneficiary can disclaim a present entitlement on becoming aware of it.

Quantum vs Proportionate Approach

The object of Div 6 is to ensure that the taxable income (“net income”) of a trust estate is taxed, either in the hands of one or more beneficiaries or the trustee. A beneficiary’s liability to pay tax is based on present entitlement to a “share of the income of the trust estate”. Where this liability exists, the beneficiary is assessed on “that share of the net income of the trust estate”.

The introduction of the CGT regime (as well as other forms of statutory income) added to the complexities of Div 6 because, depending on the terms of the trust deed, statutory income might not form part of the “income” of a trust estate. Where there is an excess of net income (i.e. taxable income) over “income” (i.e. distributable, trust income), Div 6 does not clearly explain who should be assessed on the excess. Two competing views emerged:

1. The “quantum” view – that no beneficiary is presently entitled to the excess because a beneficiary is only capable of being presently entitled to a portion of the income shown in the trust accounts (i.e. trust income), which is the income that the trustee can legally distribute for trust law purposes.[24]
2. The “proportionate” view – that a beneficiary is assessable on the same proportionate share of the net income of the trust estate as the beneficiary’s proportionate share of the trust income. For example, if the beneficiary is entitled to 20% of the trust income, that beneficiary is taken to be presently entitled to 20% of the net income, including any excess over the trust income (even if the excess is not distributed to the beneficiary).[25]

In *Davis v FCT*,[26] Hill J commented that neither view produces a desirable result as a matter of tax policy and that the scheme of Div 6 calls out for legislative clarification.

[23] [2001] FCA 164

[24] See *Richardson v FCT* (1997) 37 ATR 452

[25] See *Richard Walter Pty Ltd v FCT* [1995] FCA 480; *Zeta Force Pty Ltd v FCT* [1998] FCA 728; *Cajkusic v FCT* [2006] FCAFC 164

[26] (1989) 86 ALR 195

To complicate matters further, the Commissioner took the view that "income of the trust estate" for s 97(1) purposes means income according to ordinary concepts, and that a trust deed cannot have the effect of treating a capital receipt as income.

Under the quantum approach, each beneficiary is only assessed on an amount (quantum) of the net income (taxable income) of the trust being the amount of the income of the trust estate" (distributable income) to which they are presently entitled. The outcome of this approach was that where "net income" exceeds income of the trust estate", the excess is not attributable to any beneficiary and is therefore assessed to the trustee at top marginal rate under s.99A.

To get around that risk, it became common for trust deeds to contain an equalisation definition of trust income that equated the distributable income with s.95 net income (taxable income). It also became common for trustees to prepare distribution minutes containing resolutions that gave directions as to which beneficiaries were entitled to receive "the balance".

Under the proportionate approach, each beneficiary's share of the distributable income or income of the trust estate "as a proportion" (i.e. percentage or fraction) was to be applied to ascertain their share of the 'net income'(or taxable s.95 net income) of the trust. The outcome was that the excess amount was assessed proportionately amongst the beneficiaries who shared in the distributable income.

Bamford

FCT v Bamford [2010] HCA 10 was a test case in the High Court of Australia. It clarified two longstanding issues in respect of the taxation of trusts.

In particular, it highlighted that the amounts on which beneficiaries are assessed do not always match the amounts they are entitled to under trust law because of the differences between the concepts of trust income and net income. The decision also raised concerns about the extent to which income of a particular character (such as capital gains or franked distributions) could be streamed to specific beneficiaries.

Prior to *Bamford*, there were three different interpretations of income" or income of the trust estate in s.97(1), namely that it meant:

- ordinary income (being only income according to ordinary concepts);
- assessable income (being income according to ordinary concepts and other 'statutory income' deemed to be assessable by revenue law); or
- trust law income (being ordinary income and other amounts deemed income by trust law).

Bamford provides authority that the third meaning above is correct.

In the 2002 income year, the subject of the Commissioner's appeal, the trustee of a discretionary trust treated as distributable income a net capital gain of $29,227 arising from the sale of real property in which the trustee held a half share. That capital gain was divided equally and included in the distribution made to Mr and Mrs Bamford. Mr and Mrs Bamford each lodged a tax return for the 2002 year in accordance with that distribution.

However, the Commissioner considered that the capital gain was not included in "the income of the trust estate" of which s 97(1) speaks, with the result that there was no income of the trust estate to which s 97(1) could apply, and so assessed the trustee under s 99A.

In respect of the 2000 year, the subject of the taxpayers' appeal, the state of affairs giving rise to the dispute is more complex. In short, the issue of construction concerned the phrase "that share" in s 97(1) in circumstances where the entitlement of beneficiaries was not to fixed proportions of the income of the trust estate but, as to some beneficiaries, to specific amounts and, as to another beneficiary, to the residue – an approach commonly taken where the quantum method is applied.

The trustee determined under the deed that the income for the year ended 30 June 2000 was to be distributed, as to consecutive amounts of $643 each to a child of Mr and Mrs Bamford, the next $12,500 to Narconon Anzo Inc, the next $106,000 to the Church of Scientology, the next $68,000 to Mr and Mrs Bamford in equal shares, and the balance to that Church. The trustee determined pursuant to cl.7(n) of the deed that certain outgoings be treated as expenses and, in error, treated them as allowable deductions in computing the net income of the trust estate for the purposes of s 97(1). This was shown as $187,530.

Upon making the distributions in the above sequence, there was insufficient remaining to provide the $68,000 to Mr and Mrs Bamford, and no balance to go to the Church. There remained $67,744, which was distributed equally between Mr and Mrs Bamford (i.e. each received $33,872).

Rather than being merely $187,530, the net income of the trust estate included the non-deductible outgoings of $191,701. The Commissioner assessed Mr and Mrs Bamford by calculating the ratio which the actual distributions of $33,872 bore to the total of $187,530, and then applied that ratio to the excess of the net income addition of $191,701 over the distributable income (the proportionate method).

The Commissioner included the product of that calculation ($34,624) in the assessable income of each of the taxpayers. The taxpayers (contrary to the decision of the Full Court) contended that their share of the net income of the trust estate and thus the amounts included in their assessable incomes should have been ascertained as if the terms of the deed, including the effect of any exercise of power of appointment over income, applied to the calculation of that "net income".

The difference between the parties' submissions may be illustrated as follows. Upon the taxpayers' case, if there were trust income of $300,000 and net income of $180,000 and a beneficiary with an annuity of $100,000, the beneficiary's assessable income would be fixed at $100,000. Upon the Commissioner's case, the beneficiary's assessable income would not be fixed at $100,000 but would be the same one-third proportion (i.e. $60,000).

In arguing the case, both parties acknowledged that, whichever construction of Div 6 was accepted, examples could readily be given of apparent unfairness in the resulting administration of the legislation. The High Court held that:

- the “income of the trust estate” in s 97 means the distributable income of the trust estate as determined according to trust law and the trust deed; and
- the expression “that share of the net income of the trust estate” in s 97(1) is a reference to “proportion”. Once the share of the “income” to which the beneficiary is presently entitled has been ascertained, the beneficiary is assessed on that share (or proportion) of the “net income” (taxable income) of the trust estate. Accordingly, the proportionate approach is to be used if net income (taxable income) exceeds trust (distributable) income, based on the beneficiary’s share of the trust (distributable) income.

In relation to “income of the trust estate”, the High Court stated that:

> *36 The very juxtaposition within s 97(1) of the defined expression "net income of the trust estate" and the undefined expression "the income of the trust estate" suggests that the latter has a content found in the general law of trusts, upon which Div 6 then operates.*
>
> *37 The opening words of s 97(1) speak of "a beneficiary of a trust estate" who is "presently entitled to a share of the income of the trust estate". The language of present entitlement is that of the general law of trusts, but adapted to the operation of the 1936 Act upon distinct years of income….*

> *38 The identification in s 97(1) of "a trust estate" of which there is "a beneficiary" also bespeaks the general law of trusts….*
>
> *39 Further, the phrase "presently entitled to a share of the income" directs attention to the processes in trust administration by which the share is identified and entitlement established….*

This decision of the High Court upheld the earlier 2009 decision of the Full Federal Court. In doing so, it also confirmed similar judicial analysis from earlier cases such as *Cajkusic*, *Zeta Force* and *Richardson*.

As such, the weight of authority suggests that the trust instrument can determine by classification and reclassification what is income of the trust estate. Although the High Court in *Bamford* was silent on this issue, *Zeta Force*, *Richardson*, *Cajkusic* and the Full Federal Court in *Bamford* have unequivocally stated that the trust instrument can determine by classification and reclassification what is income of the trust estate.

In 2012, the ATO released *TR 2012/D1*, which seeks to constrain administratively the flexibility provided in *Bamford* when determining the distributable income. The ATO view expressed in that draft ruling controversially asserts that the statutory and trust law context restricts the concept of income of the trust estate, despite the terms of the trust deed. This approach is largely unsupported by legislation or judicial authority. In this draft ruling, the ATO states, among other things, that:

- income of the trust estate must be calculated by reference to distinct income years;
- income and trust estate are distinct concepts, with income being the product of the trust estate;
- income of the trust estate is net income, not gross income;
- notional income amounts (franking credits and other assessable statutory amounts such as capital gains under the market value substitution rules and Division 7A private company deemed dividend rules, controlled foreign company or transferor trust rules) may only constitute income of the trust estate to the extent of any set-off of notional expenses; and
- income applied to corpus in a previous year cannot be reclassified as income for a current year.

The ATO’s approach above has drawn criticism. It seems logically inconsistent to assert that the legislation can limit the trust deed’s operation but the trust deed’s operation cannot be expanded to deal with statutory income concepts such as notional amounts. It may be noted that the Full Federal Court’s decision in *Cajkusic* recognised a trustee’s power to determine income and rejected the ATO’s argument that trust law income cannot be governed by what is said in the trust deed.

The ATO’s rejection of *Cajkusic* is open to criticism. The ATO’s view seems to ignore the fact that the Full Federal Court in *Bamford* since held that *Cajkusic* was binding. While the High Court did not expressly comment on this issue, it ultimately upheld the decision of the Full Federal Court and did not express any reservations or doubts about the decision in the Full Federal Court. This suggests the existence of implicit High Court support for the reasoning of the Full Federal Court and the analysis in *Cajkusic*.

The High Court in *Bamford* confirmed that the proportionate approach is the correct interpretation. It is understandable why the High Court should prefer that approach over the quantum approach, as it does seem more unfair and punitive to tax a capital gain to the trustee at top marginal rate under s.99A, and without access to the CGT 50% general discount, than allow the beneficiaries to be assessed on it at a lower effective rate of tax, despite those beneficiaries not receiving the benefit of such gain. It is perceived as the lesser of two evils.

The courts have acknowledged that in some circumstances the proportionate approach may produce unfair outcomes (though it has also been observed that unfair outcomes can result from the quantum approach).

The following case studies illustrate the effects of the proportionate approach when combined with the correct meaning of "income of the trust estate" as confirmed in *Bamford*. It is important to note that, as from the 2010-11 income year, the streaming amendments would apply to these examples and may alter the outcome.

<u>Example 1</u>

> *Christie Trust has $10k rental income and $90k taxable net capital gain. The trust deed defines "income" as income according to ordinary concepts. The rental income is appointed to Archie and the net capital gain to Max. Under the proportionate approach, Archie has received 100% of the ordinary income and therefore 100% of the income of the trust estate (i.e. $10k rental income) so is taxable on 100% of the net income of the trust, which included the $90k net capital gain. Archie will be taxed on the rental income and net capital gain even though Max is entitled to receive the net capital gain (effectively tax free).*

<u>Example 2</u>

> *Poirot Trust has no ordinary income but has a $90k taxable net capital gain. The deed provides that the income of the trust is income according to ordinary concepts. The trustee appoints the net capital gain to Hercule. As there is no ordinary income, the trustee cannot make an appointment of ordinary income so that a beneficiary has a present entitlement to the income of the trust estate under s.97. As no beneficiary is presently entitled to the income of the trust estate, the trustee is taxable on the net income of the trust, being the capital gain, at top marginal rate of 45% plus 2% Medicare levy, under s.99A, without the benefit of the CGT 50% general discount*.[27]

In the above examples, if we follow *Bamford*, and the trust deed conferred a power to recharacterise capital receipts as income, it would be possible to overcome these unfair outcomes by including the capital gains in trust income and then appointing it to Hercule.

However, the ATO was horrified by prospect that trustees could manipulate tax outcomes by determining what was or was not included in distributable income, by relying on a power in the trust deed to recharacterise amounts or redefine income. The ATO's initial response to *Bamford* was to confine the High Court's decision to its facts and to list its own set of unresolved issues. In the ATO's Decision Impact Statement, the ATO maintained that the proportionate approach endorsed by the High Court did not depend on the character or class of income to which beneficiaries are entitled. That is, in the absence of any statutory provision, each beneficiary's share in the net income of the trust represents an "undissected or unallocated" proportionate amount of each class of income. In other words, the ATO denied that it was possible to effectively stream different classes of income to beneficiaries, such as franked dividends, capital gains, foreign income, primary production income and exempt income. This drew a lot of criticism from practitioners as it upset decades of administratively accepted practice.

The response of the Government was to announce a public consultation process as the first step towards updating Div 6 and rewriting it into ITAA 1997.

The Assistant Treasurer of the day, the Hon. Bill Shorten, MP, released a discussion paper on 4 March 2011, titled "Improving the taxation of trust income", which canvassed options to better align trust income with net income and to provide a legislative basis for streaming capital

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[27] The above two examples have been modified from *Trust Structures Guide, 11 edn*, Sladen Legal, A Tax Institute Publication, pp.224-225.

gains and franked distributions. As an interim measure, acting on advice from the Board of Taxation, the government enacted the streaming rules on 29 June 2011, which took effect from the 2010-11 income year. Consideration of the income alignment proposal was deferred until the proposed rewrite of Div 6, which has never eventuated.

Streaming

What does streaming involve and achieve? According to conduit theory, the character of an amount in the hands of the trustee is retained when it is distributed to the beneficiaries.

Streaming refers to the trustee's power to direct different types of income, such as franked dividends with franking credits, capital gains, foreign sources of income with foreign tax credits, exempt or NANE income to different beneficiaries of the trust, with each of those respective beneficiaries being taxed accordingly as if they derived it directly.

Conduit theory was subject to ongoing debate but was endorsed in the AAT decision in *Greenhatch v FCT*.[28] However, the AAT's decision was overturned on appeal by the Commissioner to the Full Federal Court, and an application by the taxpayer for special leave to appeal to the High Court was dismissed on 10 May 2013.

Greenhatch

During the 2008 income year, the Elke Trust trustee recorded capital receipts of $450,635 being a capital gain from the disposal of units in the Epic Events Unit Trust. It also recorded income receipts of $375,100.50 and expenses of $3,158 in its books of account.

The 30 June distribution resolutions determined that the distributable trust income included ordinary income and statutory income including net capital gains, dividend income, imputation credits, non-assessable income, and other income; and sought to stream the different categories of income as follows:

Name of beneficiary	Amount/ proportion of trust law income	Type of trust law income & amount/proportion to which each beneficiary is entitled and/or assessable					
		Net capital gains	Dividend income	Imputation credits	Non-assessable income	Ordinary income	Other income
Kevin Stanley Greenhatch		50%	-	-	50%	-	-
Christine Mary Greenhatch		50%	-	-	50%	-	-
The Homestock Trust		-	100%	100%	-	100%	100%
TOTAL	100%	100%	100%	100%	100%	100%	100%

The resolutions resolved to distribute the difference between the capital gains and the net capital gains (non-assessable capital gains) as a capital distribution to Mr and Mrs Greenhatch equally.

The resolutions also resolved to distribute the exempt income of the trust to Mr and Mrs Greenhatch equally.

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[28] [2011] AATA 479

The Commissioner agreed with the taxpayer that the effect of the resolution in equity was that the portion of the capital gain that was assessable, i.e. 50% of the gain, was to be shared equally between Mr and Mrs Greenhatch as a distribution of income from the trust, and the portion of the capital gain that was non-assessable by reason of the capital gain being a discount capital gain, i.e. the remaining 50%, was also to be shared equally between Mr and Mrs Greenhatch as a distribution of capital from the trust.

However, the Commissioner disputed that the resolutions were effective to stream the capital gain and other income between the beneficiaries for tax purposes, and as such had to be proportionately assessed to all of the beneficiaries entitled to the distributable trust income. Keep in mind that the relevant income year (2007-08) preceded the 2010-11 streaming amendments.

The net income of the Elke Trust for the 2008 income year for the purposes of s 95 of the 1936 Act was $598,563.50, calculated as follows:

Net capital gain	$225,317.50
Share of net income of the Merritts Unit Trust	$376,404.00
Less accounting fees and bank charges	($ 3,158.00)
Net income	$598,563.50

The Tribunal observed that the wider system of taxing income derived by trustees, such as dividend, interest and royalty withholding and franked distributed suggested a look-through approach fastening on a particular character of amounts to which beneficiaries are entitled. The Tribunal stated:

> *64. The conclusion that we reach is that s 115-215 of the 1997 Act is a section that the legislature enacted at a time before there was any caution directed to the decision of the High Court in Charles which is consistent with a suite of provisions that identify:*
>
> *(a) particular amounts of income or capital gains of trust estates;*
>
> *(b) beneficiaries' particular entitlements to those amounts; and*
>
> *(c) recognise those amounts in the hands of the beneficiaries with the same character as they had in the hands of the trustee.*
>
> *65. Where the terms of the trust allow identification of who is entitled to what, in our view the legislature intended that the taxation treatment follow on a differentiated basis among beneficiaries.*

The Commissioner appealed the Tribunal's decision. The Full Federal Court[29] allowed the Commissioner's appeal and held that a beneficiary's assessable income under s.97 consisted of an undissected proportionate share of all of the trust's taxable income, that is, a "blended" amount. Each beneficiary of the trust would be treated as having an extra capital gain (and other classes of income), even though they had no entitlement to the capital gains of the trust under the trust deed.

On 1 August 2012, Mr Greenhatch applied to the High Court for special leave to appeal the Full Federal Court decision. On 10 May 2013, the High Court refused leave on the basis that no question of law or public importance was raised and there were insufficient prospects of

[29] [2012] FCAFC 84

success on any appeal to warrant the grant of special leave. Perhaps the High Court considered the issue was academic following the 2010-11 streaming amendments?

The result of *Greenhatch* means that while different types of income still retain their character in the hands of beneficiaries, the tax law does not recognise a trustee's determination to stream a particular type of income to a particular beneficiary. Following *Bamford*, and in accordance with the view adopted by the ATO, beneficiaries are to be assessed on a proportionate share of the blended amount of the taxable income of the trust.

This is the case except for capital gains and franked distributions, which are the subject of legislative amendments which allow streaming for those specific types of receipts.

Streaming Rules

With effect from the 2010-11 income year, the *Tax Laws Amendment (2011 Measures No 5) Act 2011* (**TLAA No.5**) enacted the following "interim" measures in response to problems highlighted by the High Court's decision in *Bamford*:

(1) enacted Div 6E, which modifies the operation of Div 6 by excluding capital gains and franked distributions from the calculation of amounts under ss.97 to 100 of the ITAA – to prevent double taxation by adjusting amounts otherwise assessable to beneficiaries (or the trustee) under Div 6 – and providing a clear legislative basis for streaming capital gains and franked distributions to beneficiaries with "specific entitlement". Division 6E was enacted as a separate division to avoid making direct changes to Div 6 pending the proposed rewrite of the trust provisions;

(2) enacted the exempt entity anti-avoidance provisions, which deem a tax-exempt entity not to be presently entitled to income if the trustee failed to notify the exempt entity in writing of the present entitlement or where the exempt entity is not specifically entitled to the capital gain or franked distributed; and

(3) amended the CGT and franked distribution provisions to tax those amounts under Subdiv 115-C and Subdiv 207-B of the ITAA respectively.

Although no amendments were made to the key provisions in Div 6, these changes significantly affect the operation of Div 6.

Division 6E only applies if a trust has a positive net (taxable) income that includes a capital gain or franked distribution (including franking credits). If it does, the income of the trust estate, the net income of the trust estate and the present entitlement of a beneficiary are all calculated to exclude the capital gain and franked distribution (including franking credits). Franked distributions can be streamed even if they are only partly franked.

Where there is a capital gain or franked distribution and the trust has a positive taxable income, Div 6E has mandatory operation. It is not an opt in or out regime. Trustees shouldn't assume that if they decide not to stream a capital gain or franked dividend that they can still deal with it as part of the Div 6 distributable income or net income by making beneficiaries presently entitled to it. That won't work.

Division 6E effectively replaces "presently entitled", "income of the trust estate", and "net income of the trust estate" with "Division 6E presently entitled", "Division 6E income of the trust estate", and "Division 6E net income of the trust estate". Each definition excludes any capital gains and franked distributions (including franking credits).

The amount of a beneficiary's "Division 6E present entitlement" is decreased by the beneficiary's share of the capital gain and franked distribution included in the income of the trust estate.

Through the process of disregarding or decreasing capital gains and franked distributions, those amounts are then taxed under Subdiv 115-C and Subdiv 207-B. The interaction of those provisions has altered the potential liability to tax of certain amounts of income.

Div 6E operates differently from Div 6 as it taxes:

- the specifically entitled beneficiary on the capital gains or franked distributions of the trust at marginal or corporate tax rates;
- the Div 6E presently entitled beneficiary not under a legal disability on the Div 6E net income of the trust (i.e. income other than capital gains and franked distributions) at marginal or corporate tax rates depending on whether the beneficiary is an individual or corporate taxpayer;
- the Div 6E presently entitled beneficiary who is not under a legal disability on a proportion of the capital gains or franked distributions of the trust to which no beneficiary is specifically entitled;
- the trustee on behalf of the Div 6E presently entitled beneficiary or specifically entitled beneficiary under a legal disability on the net income of the trust at marginal tax rates; or
- the trustee on the net income of the trust to which no beneficiary is Div 6E presently entitled or specifically entitled.

How do you make a beneficiary specifically entitled?

The streaming rules (Subdivs 115-C and 207-B) use the concept of "specific entitlement" to determine whether a beneficiary is assessed on a capital gain or franked distribution.

While present entitlement requires a beneficiary to have both a vested and indefeasible interest in trust property and the legal right to demand immediate payment, specific entitlement can be made out where there is a vested and indefeasible interest but not an immediate obligation to make the payment.

A beneficiary has a specific entitlement to a capital gain or franked distribution if the beneficiary receives, or can reasonably be expected to receive, an amount equal to the **net financial benefit** referable to the capital gain or franked distribution, and the entitlement is recorded in the accounts or records of the trust in its character as a capital gain or franked distribution.

A beneficiary is "specifically entitled" to a capital gain made by the trust estate calculated by the formula:

Capital gain x Share of net financial benefit ÷ Net financial benefit

A "financial benefit" is anything of economic value, including property or services. No beneficiary or trustee can be specifically entitled to a purely notional capital gain (e.g. a market value substitution gain or a deemed capital gain from a trust ceasing to be a resident trust). This is because there is no net economic benefit referable to the notional gain that beneficiaries can receive. So notional capital gains are taxable proportionately to beneficiaries that received income.

A capital gain arising to the trustee as a result of CGT event E5 happening, e.g. on a beneficiary becoming absolutely entitled to a trust asset as against the trustee, is not treated in the same way as a notional capital gain. Even though market value substitution applies and no actual capital proceeds are received by the trustee in exchange for the asset when CGT event E5 occurs, the ATO and Treasury's position[30] is that when a beneficiary becomes absolutely entitled to a trust asset, it may be reasonable to expect the beneficiary will receive the net financial benefit referable to the deemed (trust) capital gain from CGT event E5. The ATO has administratively supported this view when asked this question in private ruling applications.[31]

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[30] See para.2.59 of *Explanatory Memorandum to Tax Laws Amendment (2011 Measures No 5) Bill 2011*.

[31] See e.g. PBR Authorisation Number: 1013025567687 at https://www.ato.gov.au/law/view/document?src=as&pit=20190930000000&arc=false&start=1&pageSize=50

The financial benefit must be referable to an amount "received" or reasonably expected to be received.

In order to quantify the "net financial benefit", it is necessary to deduct from the actual proceeds of the trust ("financial benefit") by trust losses or expenses (subject to certain conditions).

A beneficiary is reasonably expected to receive an amount if the beneficiary is presently entitled to the amount, has a vested and indefeasible interest in the trust property representing the amount or the amount has been set aside exclusively for the beneficiary.

Streaming does not require an equitable tracing to the actual trust proceeds from the event that gave rise to the capital gain or the receipt of a franked distribution. As such, it does not matter that the proceeds from the sale of an asset or a franked distribution were reinvested during the year, provided that a beneficiary receives or can be expected to receive money or property equivalent to their share of the net financial benefit.

"Share of net financial benefit" means the amount of financial benefit that, in accordance with the terms of the trust, the beneficiary has received or is reasonable expected to receive that is referable to the capital gain and recorded in its character as referable to the capital gain in the trust's accounts no later than 2 months after the end of the income year (by 31 August).

The net financial benefit referable to a capital gain will generally be the trust proceeds from the transaction that gave rise to the CGT event reduced by any costs incurred in relation to the relevant asset. This may be further reduced by other trust losses of a capital nature, to the extent consistent with the application of capital losses for tax purposes.

The net financial benefit referable to a franked distribution will normally equal the amount of the franked distribution after being reduced by directly relevant expenses, e.g. any borrowing expenses, such as interest, incurred in respect of the underlying shares (allocated rateably against any franked and unfranked dividends form those shares), or management fees incurred in respect of managing an investment portfolio of shares for the purpose of deriving dividend income (allocated against dividend income as relevant).

One trap under the streaming rules is that it is not possible stream tax amounts to beneficiaries where there is no referable net financial benefit remaining in the trust, such as when the gross benefit has been reduced to zero by losses or directly relevant expenses. It is also not possible to make a beneficiary specifically entitled to franking credits, or to separately stream franked distributions and franking credits.

A taxpayer tried that argument in the case of *Thomas & Ors v FCT*, and lost.[32] In that case, the trustee of a discretionary trust resolved to distribute franking credits to an individual beneficiary independently of the franked dividends to which the franking credits attached. The High Court rejected the argument that because the resolutions were passed in the beneficiaries' presence and they "acquiesced" in the tax returns lodged, the rights between the beneficiaries were fixed by the trustee's actions and the Commissioner was estopped from administering the tax legislation in accordance with the law. The High Court said that the Commissioner is obliged to administer the tax statutes according to law and that:

> *"the justice of an estoppel would not permit parties to create a private arrangement which produced an outcome contrary to law or … which required a statutory officer to administer the taxing statutes other than according to law".*

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[32] *FCT v Thomas and Ors* [2018] HCA 31

One positive aspect of the streaming rules is that a specifically entitled beneficiary will not be assessed on any share of the trust's net income over and above the amount of the specific entitlement unless the beneficiary has a present entitlement to other income of the trust.

Further, franking credits can still flow proportionately to beneficiaries that have a share of a trust's positive income for an income year even where the franked distributions of the trust are offset entirely by expenses.

The entitlement to a franked distribution must be recorded by 30 June, while the entitlement to a capital gain must be recorded by 31 August. A resolution to make a beneficiary specifically entitled to a capital gain or franked distribution must be made by 30 June.

Depending on the circumstances, a beneficiary can be specifically entitled to receive a share of the net financial benefit of a capital gain even if the making of the capital gain is not established until after the end of the income year, e.g. because a contract for the sale of the asset settles after the end of the income year.[33]

Implications for Trust Deeds and Distribution Minutes

Trust Deeds

It is critical that the trust deed empowers the trustee to:[34]

- classify and account for the trust's income separately according to its source (in particular, capital gains and franked dividends);
- allocate capital losses against capital gains and 'relevant expenses' against franked dividends in a corresponding way;
- distribute amounts of capital gains and/or franked dividends to beneficiaries once they have been classified and accounted for in their character as capital gains and/or franked dividends, and alternatively, to advance or distribute trust capital (in some deeds called 'corpus');
- pay, apply or set aside an amount in favour of a beneficiary.

Below are sample trust deed clauses that facilitate streaming:

(a) The Trustee may at any time determine:

(i) to pay, apply or set aside any Net Income of an Accounting Period for any one or more General Beneficiary extant at the time of the determination; or

(ii) to accumulate any Net Income of an Accounting Period.

(b) The Trustee may … at any time before the Vesting Day raise any amount out of the Capital of the Trust Fund and pay it or transfer the whole or part of the Trust Fund … to any Beneficiary for the maintenance, education, advancement or benefit of that Beneficiary.

(c) The Trustee may establish in the accounting records of the Trust separate accounts and ledgers for each separate category or class of income showing the nature, source and accounting for the income and the expenses relating to that income made in the Accounting Period.

[33] TD 2012/11

[34] See e.g. Hall & Wilcox (2015) *Trust Streaming Manual*, CPA Australia.

(d) The Trustee has the power to make determinations and to record in the Trust's books of account and other records as to:

(i) the amount of any financial benefit (as defined in the ITAA) as to any receipt, gain or other amount derived by the Trustee in the course of the Trust;

(ii) any Beneficiary's share of financial benefit (as defined in the ITAA) as to any receipt, gain or other amount derived by the Trustee in the course of the Trust;

(iii) the amount or share any Beneficiary is entitled to (as defined in the ITAA) as to any receipt, gain or other amount derived by the Trustee in the course of the Trust; and

(iv) identifying, by character, any receipt, gain or other amount derived by the Trustee in the course of the Trust.

(e) Subject to the entitlement of a Beneficiary under clause A to any Net Income, the Trustee may allocate particular Net Income (however identified in the books of the Trust Fund) or any mix in whole or part satisfaction of the entitlement of that Beneficiary under clause A, to an amount of Net Income and that Beneficiary will be absolutely entitled to that part of the Net Income so allocated.

(f) For the purpose of identifying the Net Income to be allocated pursuant to clause A(b), the Trustee may establish separate accounting records and ledgers to which particular Net Income may be credited and to which the Trustee may:

(i) allocate and debit particular expenses or losses; or

(ii) attribute particular dividend imputation or other tax credits or rebates relating to the Net Income that are in the Trustee's determination attributable to that Net Income.

(g) Subject to the entitlement of a Beneficiary under clause X to an amount of Capital of the Trust Fund before the Vesting Day, the Trustee may allocate particular Capital of the Trust Fund in satisfaction or partial satisfaction of the entitlement of that Beneficiary to an amount of Capital of the Trust Fund and that Beneficiary will be absolutely entitled to that allocated part of the Capital of the Trust Fund.

(h) Subject to the entitlement of a Beneficiary under clause Y to an amount of Capital of the Trust Fund on the Vesting Day, the Trustee may allocate particular Capital of the Trust Fund (however identified in the books of the Trust Fund) in whole or part satisfaction of the Beneficiary's entitlement to Capital of the Trust Fund under clause Y.

(i) For the purpose of identifying the Capital of the Trust Fund to be allocated pursuant to clauses X and Y), the Trustee may establish separate accounting records to which particular Capital of the Trust Fund may be credited and to which the Trustee may allocate and debit particular expenses, losses or income including tax credits or rebates as the Trustee determines.

(j) If the Trustee so resolves, any amount set aside for any Beneficiary under clause A, B or C will not form part of the Trust Fund but will be held by the Trustee as a separate trust fund on trust for that person absolutely, with power in the Trustee to invest or apply or deal with that fund in the manner provided for in this deed.

The trust deed needs to contain adequate streaming clauses, a power to undertake differential streaming and a flexible definition of income. The streaming amendments do not in any way give trustees a power to stream where they do not already have the power to do so.

A specific entitlement can be created in a capital gain regardless of whether the capital gain is appointed under the income clause or capital clause of the trust deed, but the outcome depends on the terms of the trust deed, the definition of distributable income and the terms of the trustee distribution minutes. The same result can be achieved as Div 6E disregards the capital gain included through Div 6.

Where the trust deed equates distributable income with s.95 net income, it is useful to also have a power to reclassify receipts and outgoings in order to create the necessary specific entitlement to a capital gain or franked distribution.

Trust deeds should be reviewed and, if necessary, amended to include these powers, though most modern discretionary trust deeds already do. Any amendment to a trust deed must be done in a careful and considered manner, to ensure that any proposed amendment falls within the variation power and won't give rise to a resettlement.

If the trust deed defines distributable income as income according to ordinary concepts and trust law, then the simplest way of streaming a capital gain to a beneficiary is for the trustee to exercise their capital distribution power, to cause a beneficiary to be specifically entitled to the whole of the capital gain as a capital distribution. Be mindful that sometimes the trust deed will require the consent of a guardian or other office holder for distributions of capital.

If the trust deed equates distributable income with s.95 net income (taxable income), it is still possible to stream a capital gain. The assessable portion of the capital gain will already be included in the distributable income. However, the non-assessable discount portion of the capital gain won't be included in the distributable income.

To achieve streaming in such a case, the trust deed needs to confer a power on the trustee either to recharacterise a capital receipt as income or to redefine income so as to allow the non-assessable portion of the capital gain to be included in the assessable income; or alternatively to exercise the capital distribution power to distribute the non-assessable portion of the capital gain as a capital distribution. If you only cause a beneficiary to be specifically entitled to the assessable portion, that won't be effective to stream the capital gain. You need to make sure that both the assessable and non-assessable portions are streamed to the same person in the same income year.

The streaming rules place an obligation on the trustee to record the specific entitlement in the accounts or records of the trust within the prescribed time. The trust accounts and records can provide valuable evidence to substantiate the trustee's compliance with the streaming rules.

Trustee Resolutions

The TLAA No. 5 requires that the trustee record the capital gain "in its character as referable to the capital gain" in the trust's accounts no later than two months after the end of the income year. Generic trustee resolutions that appoint "the balance" of trust income, "all of the trust income", "half of the trust income", or "$100 of trust income" will not suffice as they do not specifically record the character even if factually the appointment contains some or consists entirely of a capital gain. Accordingly, a detailed specific resolution is required that refers to the character of the income and not just generic trust income.

There are various styles of acceptable distribution resolutions. A choice is generally made between proportionate distributions or specific amount distributions.[35] In order to ensure that a distribution resolution complies with the streaming provisions, it should record clearly:

- the particular powers under the terms of the trust deed that have been relied on by the trustee to create the specific entitlement to a capital gain or franked dividend in favour of the beneficiary, identifying the provisions of the trust deed that enable classification of the trust's income (or capital) by its type and distribution of that type of income (or capital) to the relevant beneficiary;
- that the capital gain or franked dividend is being specifically allocated to the relevant beneficiary in its character as a capital gain or a franked dividend – it should record the trustee's decision to create an account for income or capital representing franked dividends and capital gains (as the case may be), allocate the franked dividends or capital gains to the relevant account, once created, and then effect a distribution of an amount to the beneficiary from the account recording the capital gains and franked dividends. If only the assessable portion of the capital gain is included in income, according to the income definition in the trust deed or as resolved, then the resolution should also make a further distribution, of capital, to the beneficiary, such that they receive the entire 'financial benefit' referrable to the capital gain. For clarity, the distribution minute should also explicitly state that the distribution to the beneficiary is of an amount 'in its character' as a capital gain or a franked dividend;
- the flow of funds that will enable payment of the amount of the financial benefit referable to the capital gain and/or the franked dividends to which the beneficiary is specifically entitled;
- that this financial benefit is to be paid or, under the terms of the trust, held specifically for the sole benefit of the beneficiary under a sub-trust.

The entitlement of a beneficiary when streaming can be expressed as a share of the trust capital gain or distribution. More generally, the entitlement can be expressed using a known formula even though the result of the formula is calculated later. For example, a trustee could resolve to distribute to a beneficiary:[36]

- $50 referable to a franked distribution;
- half of the 'trust gain' realised on the sale of an asset;
- the amount of franked distribution remaining after calculating directly relevant expenses and distributing $10 to another beneficiary;
- 30% of a 'net dividends account' that includes all franked and unfranked distributions, less directly relevant expenses charged against the account (so long as their entitlement to net franked distributions can be determined); and
- the amount of (tax) capital gain included in the calculation of the trust's taxable income remaining after the application of the CGT discount. In such a case the beneficiary might at best argue it is specifically entitled to only half of the gain, and that entitlement is taken to be made up equally of the taxable and discount parts of the gain.

In relation to streaming franked distributions, a trustee may choose to appoint franked distributions as a single class. If the trustee deals with all of the franked distributions received by the trust as a single 'class' (or as part of a broader class), the provisions apply to the total franked distributions as if they were a single franked distribution. Therefore, if a beneficiary is entitled to receive all (or a share) of the entire class of net franked distributions of a trust and the class is in an overall gain position, the beneficiary can be specifically entitled to all (or that share) of the entire class of franked distributions, even if a particular franked distribution was more than offset by directly relevant expenses. What matters is that the trustee distributes the

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[35] See e.g. *Trust Structures Guide, 11 edn*, Sladen Legal, A Tax Institute Publication at p.263

[36] See e.g. Hall & Wilcox (2015) *Trust Streaming Manual*, CPA Australia.

franked distributions as a single class. It is not sufficient (or necessary) that the trustee records the receipt of the franked distributions as a single class.

Where the trust deed equates distributable income with s.95 net income (taxable income), unless you modify the definition to exclude the franking credit portion of assessable income and other notional amounts, such as market value substitution rule capital gains and Division 7A deemed dividends, it can give rise to an inflated UPE in favour of the beneficiary, requiring the trustee to deplete the capital or corpus of the trust fund in order to pay out those entitlements.

If the trustee does not pool all the franked distributions and attempts to specifically stream certain franked distributions to particular beneficiaries, then the single class rule will not apply and the trustee must appoint franked distributions on a dividend by dividend basis. Further, the trustee must reduce the franked distribution class of income by all directly related expenses.

Another trap can arise where the trust has positive distributable income when 'notional' amounts are taken into account but a negative distributable income when those amounts are excluded. This can arise, for example, where a trust has tax deductible interest expenses, say a margin loan over shares. If imputation credits are included in the trust's distributable income (because of an income equalisation clause or a trustee's determination), the trust would have a positive distributable income overall. However, if the imputation credits are excluded from the trust's distributable income because they are 'notional' amounts, consistent with the ATO's views in *TR 2012/D1*, then the trust's adjusted distributable income may be negative overall. In the latter case, as there is no 'distributable' net income, a distribution cannot be made to any of the beneficiaries. As the imputation credits cannot flow through to the beneficiaries, they are wasted.

It is generally advisable to use percentages rather than dollar figures wherever possible (e.g. "50% to X and 50% to Y" rather than "$50,000 to X and $50,000 to Y" or "$50,000 to X and the balance to Y"). If additional amounts were not contemplated at the time of the distribution as in Richardson's case and are later assessed as income, the use of percentages will ensure that:[37]

- beneficiaries are presently entitled to all the additional income; and
- the beneficiaries are presently entitled to all that additional income in the same proportions as originally intended.

If it is intended that a particular beneficiary be taxed on the whole of any such additional assessed income, then the "$50,000 to X and balance to Y" expression is appropriate.

Where income or expenses are specifically dealt with in a particular manner, there may be no mechanism to reverse the treatment on a reassessment.

Practitioners should be wary of making contingent or conditional resolutions, as they may not be effective to create a present entitlement to distributable income.[38] Sometimes they are used in an attempt to achieve a particular after-tax outcome for each beneficiary, or anticipate what should happen in the event that the Commissioner re-assesses the taxable income of the trust.

For a beneficiary to be presently entitled to trust income, their right to the income must be indefeasible. That is, the entitlement must not be capable of being taken away. If an entitlement to trust income can be taken away from a beneficiary then the trustee may be assessed on the corresponding part of the trust's net (taxable) income.[39]

[37] See e.g. *Trust Structures Guide, 11 edn*, Sladen Legal, A Tax Institute Publication at p.258

[38] *TD 2012/22* at para 64

[39] https://www.ato.gov.au/General/Trusts/In-detail/Trust-tax-time-toolkit/Resolutions-checklist/

Taxation Determination TD 2012/22 discusses the consequences of an amended assessment in respect of various forms of resolutions and trust deeds. The ATO accepts that default distribution clauses in trust deeds are effective where distributable income is equated to s.95 net income (taxable income), and that 'balance distribution resolutions' are effective where distributable income is equated to s.95 net income (taxable income).

Similarly, some practitioners have attempted to shelter beneficiaries from an adverse assessment by preparing resolutions that distribute so much distributable income as to create a taxable result.

Ruling compendium *TD 2012/22EC* questions whether such resolutions are effective. It has been asserted that arguably such resolutions are effective on the basis that the trustee is dealing with distributable income, not taxable income. Below is an example of such a resolution:[40]

> *First, such amount of the distributable income (excluding franked dividends and capital gains) as bears to the total income of the trust comprising all such income, the proportion that, when the share of the net income of the trust under s.97 of the Tax Act is determined, provides the amount of $416 to [name].*
>
> *Then such amount of the distributable income as bears to the total income of the trust comprising all such income, the proportion that, when the share of the net income of the trust under the Tax Act is determined, provides the amount of $X to [name].*
>
> *The balance of distributable income to [name].*

Exempt Entities – Anti-Avoidance Rules

TLAA No.5 introduced specific anti-avoidance rules that prevent the inappropriate use of exempt beneficiaries to shelter taxable income of a trust.

Broadly, the specific anti-avoidance rules apply where a beneficiary that is an exempt entity is not notified or paid their present entitlement to income of the trust; or where an exempt beneficiary would otherwise be assessed on a share of a trust's taxable income that is disproportionate to their overall trust entitlement.

An exempt entity is taken not to be presently entitled to any amount of the trust's income unless they have either been paid or notified of their entitlement, within two months of the end of the income year. The amount that would otherwise be that beneficiary's share of taxable income is assessed to the trustee.

Where an exempt entity is used to 'shelter' a share of the taxable income of a trust that exceeds the exempt entity's entitlement to the net accretions to the trust underlying that taxable income (whether 'income' or 'capital' of the trust), that excess is assessed to the trustee.

The ATO has also flagged that it would investigate any deliberate attempts to exploit Div 6. For example, on 12 August 2013, the ATO issued *Taxpayer Alert TA 2013/1* titled "Arrangements to exploit mismatches between trust and taxable income".

The ATO stated that it was reviewing artificial arrangements where a deliberate mismatch is created between the amounts that beneficiaries are entitled to receive from a trust and the amounts they are taxed on.

The arrangement in this particular Taxpayer Alert involved a trust that generated a small amount of income and a large capital gain during the year. Trust distributions were made so that one beneficiary received the funds generated from the capital gain, tax free, whilst another beneficiary (a new incorporated company) received the tax liability attached to that capital

[40] See e.g. *Trust Structures Guide, 11 edn*, Sladen Legal, A Tax Institute Publication at p.264

gain. The newly incorporated company received no funds from the capital gain to pay this tax liability, and winding-up proceedings were commenced. This process was designed to avoid the payment of tax on the large taxable capital gain.

Other exploitive practices that the ATO has been concerned about include:

1. Characterising expenses that would ordinarily be capital in nature on income account, thereby reducing the trust's distributable income to a nominal amount which is appointed to loss beneficiaries. As 100% of distributable income is appointed to loss beneficiaries, all of the trust's tax law income is effectively tax free. The ATO has concerns that this is, in effect, accumulated income that would ordinarily be assessed to the trustee at the highest rate.

2. Characterising a majority of a trust's ordinary income as capital and amending the deed to include tax exempt charities as beneficiaries, which are then appointed the nominal distributable income, with capital receipts distributed to family members. As 100% of distributable income is appointed to tax-exempt charities, all of the trust's tax law income is effectively tax free.

Examples of Tax Problems Post-Bamford and Streaming

Bamford has resolved a number of fundamental issues about the operation of Div 6. It confirmed that there is potential flexibility when determining the income of the trust estate.

While the provisions of TLAA No.5 achieve the desired outcome in respect of the ability to stream capital gains and franked distributions (where the trust deed includes the necessary powers), the provisions are complex and require careful application to ensure the intended specific entitlement is created, and not unintended tax consequences. The provisions of the trust deed and distribution minutes are more critical than ever in ensuring that effective distributions are made.

In short, streaming can overcome the problem identified in *Bamford*, where there is a capital gain but no positive distributable income. You can make sure a beneficiary is assessed on the capital gain, rather than the trustee paying top marginal rate tax and without getting the CGT 50% general discount. But it won't work for all capital gains, such as notional market value substitution gains. Streaming will also work for franked distributions, whether fully franked or partly franked.

However, streaming won't be effective for other categories of receipts and income, such as foreign income, unfranked dividends, interest income, rental income, primary production income, non-primary production business income or exempt or NANE income. Where you have a trust with different categories of income, gone are the days when you can stream foreign income (including tax-exempt conduit foreign income, such as non-portfolio dividends, received by an Australian company and paid as an unfranked dividend) to non-resident beneficiaries and thereby shelter that income from tax by keeping it outside the Australian tax net.

Even if the trust deed authorises streaming of foreign income and the trustee exercises that power in favour of a non-resident, that allocation of foreign income won't be binding on the Commissioner for tax purposes. The Commissioner can treat that as just a dollar figure like all the rest of the income of the trust, then work out the proportionate entitlements to distributable income, and allocate the foreign income proportionately to all of the beneficiaries.[41]

<u>Example 3</u>

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[41] See e.g. Brydges, N. & Yuen, K. 'Trusts, income tax, CGT and foreign residents' in *Taxation in Australia*, August 2018 at pp.80-82 (the example now given in this paper is extracted from this article).

An Australian trust derives $300 of interest, $300 of rent and $300 of unfranked dividends (that are declared to be conduit foreign income). The trustee makes Foreign Resident A presently entitled to the interest, an Australian resident presently entitled to the rent, and Foreign Resident B presently entitled to the conduit foreign income.

Each beneficiary will be assessed on a proportionate share of all the net income. That is, each beneficiary will, in effect, be assessed on $100 each of interest, rent and unfranked dividends. For the Australian resident, the $300 will be assessed under s.97 with the conduit foreign income being an unfranked dividend.

For the foreign residents, the $100 of interest will be subject to withholding tax under Div 11A, the $100 rent will be assessed to the trustee and the beneficiary under ss 98 and 98A, while the $100 of conduit foreign income will be non-assessable non-exempt.

If you want to effectively stream those other categories of income, your only option now is to set up different trusts each holding the separate assets that respectively generate the different categories of income. This is a ridiculous state of affairs.

In relation to non-resident beneficiaries and streamed capital gains, it may be noted that the amendments made by TLAA No.5 ensure that in appropriate circumstances, a trustee will continue to be assessed and liable to pay tax under s.98 in respect of amounts now dealt with under the rules in Subdiv 115-C.

Where a beneficiary who is treated under Subdivision 115-C as having an 'extra capital gain' is a non-resident at the end of the income year in which the capital gain was made by the trustee, the trustee may be assessed under s.98(3) on all or some part of the beneficiary's extra capital gain - despite the rules in Div 6E. This outcome arises by operation of s.115-220.

If s.115-220 applies to assess the trustee under s.98 in respect of a trust capital gain, then the amount of the capital gain assessed to the trustee is the beneficiary's attributable gain worked out under s.115-225 with reference to s.115-227. This is, broadly, so much of the capital gain to which the beneficiary was specifically entitled as remains following application of the trustee's capital losses and relevant CGT discounts and CGT concessions. It is the gain the beneficiary is taken to have made before it is doubled or grossed up by the beneficiary as required under s.115-215(3).

Applying these principles to a capital gain made by a trustee from CGT event E5:

- The trustee may be assessed and liable to pay tax under s.98(3).
- The beneficiary may be taken to have an 'extra capital gain' under Subdiv 115-C, which the beneficiary must take into account in working out their own net capital gain or loss under s.102-5.

As such both the trustee and the beneficiary may have a liability to tax. In those circumstances, each is separately and independently liable. However, the income tax assessed to the beneficiary is effectively reduced by any tax paid by the trustee. If the tax paid by the trustee exceeds the tax assessed to the beneficiary, then the Commissioner must pay that excess to the beneficiary: s.98A(2).

While the application of Div 6E means the beneficiary will not have been assessed under s.98A(1), which would normally have been the trigger for a s.98A(2) credit, s.95AAB ensures that the amount included in the beneficiary's assessable income because of Subdiv 115-C is deemed to be included in their assessable income under s.98A(1) for the purpose of the credit provision in s.98A(2).

Where there is no beneficiary specifically entitled to a capital gain or a franked distribution, the beneficiaries who are entitled to other classes of income are proportionately taxed on the capital gain or franked distribution. It is only where there are no other classes of income or there are no beneficiaries presently entitled to those classes of income that the trustee is taxable under s.99 or 99A.

This can cause unfavourable tax outcomes, as the key benefit of streaming is to allow capital gains and franked dividends to be assessed to the beneficiary as that specific type of income based on their individual tax profile and attributes (e.g. in the case of capital gains, to an individual able to access the 50% CGT discount; or in the case of franked dividends, to a resident beneficiary who can offset the franking credit against other assessable income or even obtain a franking credit refund).

The current law can also still leave undesirable and unfair tax outcomes for trustees and beneficiaries of trusts which create fixed lifetime entitlements to income to one class of beneficiary and a fixed entitlement to capital in remainder to a separate class of beneficiary.

Example 4

> *The trustee of the Cavendish Trust, established in 1988, owns a commercial property in the Perth CBD, which generates $100k pa of net rental income. The property has a cost base of $17m. It was transferred into the trust by Lady Cavendish, the matriarch of the family, during her lifetime. The trust divides the income and capital between different beneficiaries in fixed shares. There are currently 5 income beneficiaries, being the surviving children of Lady Cavendish. Until those children all die, the income must be divided equally between each child then living. The capital beneficiaries consist of the surviving grandchildren of Lady Cavendish who are still alive when all 5 income beneficiaries die, who will then share in the capital of the trust in equal shares.*
>
> *The terms of the trust do not provide a definition of income or empower the trustee to treat / recharacterise income receipts and outgoings as being on capital account, or vice versa.*
>
> *The 5 income beneficiaries are each presently entitled to $20k of net rental income during the year. However, near the end of the year, the trustee sold the property for $42m, giving rise to a gross capital gain of $25m. Who should be assessed on the capital gain?*
>
> *Under the terms of the trust, there is no power to distribute the capital to any beneficiary until after all of the income beneficiaries have died. Nor is there a power to amend the terms of the trust to allow income or capital receipts to be recharacterized or to allow an early distribution of capital to any of the beneficiaries.*
>
> *Applying s.97, the income beneficiaries would be assessed for the capital gain in the same proportions as they are presently entitled to the Div 6E distributable income of the trust (which includes only the rental income). As each beneficiary is presently entitled to an equal 1/5 share of the Div 6E, they will each be assessable on $20k of rental income and on $2.5m of net (discounted) capital gains (being $5m gross capital gain each, discounted by the CGT 50% general discount to $2.5m), assuming they are all Australian residents for tax purposes.*
>
> *One of the income beneficiaries, Mary, relies solely on the income of the trust to meet her costs of living. She has no other sources of income. Normally her tax bill on $20k income is negligible ($20k minus $18.2k tax free threshold) x 19% tax rate = $342.*
>
> *However, this year Mary's taxable income will be $2.52m and her tax bill will exceed $1.1m. Mary will have no recourse to any of the sale proceeds from the property, as the trustee is required to preserve any capital for the capital beneficiaries. The tax bill will cause Mary to become bankrupt, and the ATO will in turn have no option but to write off a significant portion of the tax bill.*

Similar tax bills are sent to the other income beneficiaries. The assessments total around $5.5m. What are their options? Is there any alternative?

Alternative 1 – The trustee applies to the Supreme Court to vary the terms of the trust to authorise a once off capital distribution to the income beneficiaries in order to cover their tax bills, or to insert a recharacterisation clause to empower the trustee to treat a portion of the capital receipt as being on income account. There is no guarantee that the Court would order this.

Alternative 2 – Let's be mean and just let the income beneficiaries go bankrupt. What's so bad about going bankrupt? On the plus side, the ATO might only end up recovering a small % of its tax debt. The rest of it is written off. No recourse against the trustee or the trust assets. The trust retains the $42m. This means no trust fund depletion at all. Think of all the extra income it could generate in future years. The income beneficiaries might not like it, being turfed out of their homes. But how long does bankruptcy last? 3 years and 1 day after filing your statement of affairs. The trustee could also structure its investment of the proceeds to ensure the trustee in bankruptcy had no income to take from the beneficiaries over those 3 years. It would be quite easy for the trustee to invest the $42m in a term deposit or bonds that only paid out in maturity in 3 or 4 years. Doesn't that sound devious?

Alternative 3 – One or more of the beneficiaries disclaim their income entitlement for the year. Is that possible under the terms of the trust? Can they disclaim for a particular year? Or would they have had to disclaim from the very beginning of the trust? What is the effect of disclaimer? Are the other beneficiaries' entitlement enlarged, rather than reverting to the trustee?

Alternative 4 – Another option available under the tax law is that the trustee could make an election to be taxed on the capital gain under s.99A pursuant to s.115-230. S.99A applies because we have assumed the trust was created inter vivos, not by will. Applying s.99A, the trustee is assessed on the gross capital gain of $25m at 47%. Overall that's around $11.75m payable by the trustee. The trustee has a right of indemnity to pay this tax bill out of the trust fund. So in a short space of time, after applying the relevant taxing provisions, the trust fund is depleted from around $42m to around $30m.

Actual – Fortunately, in the real life scenario, the trust was created by will, so by the trustee electing to be assessed, s.99 would apply instead of s.99A. Applying s.99 enables the trustee to access the CGT 50% general discount, effectively cutting the tax bill in half, to around $5.875m, meaning the trust fund would have only been depleted to around $36m. This is a situation where it is very useful for the trustee to elect to be taxed on a capital gain.

Example 5

Hastings Trust owns a share portfolio which generates both franked and unfranked dividends.

During the year the trustee vested a parcel of shares as an in-specie capital distribution to Japp (for no consideration), realising a market value substitution capital gain of $300 (discounted to $150). The trust derived $1 interest income from the trust's bank account, $70 franked dividends and $99 unfranked dividends.

At year end, the trustee resolves to distribute the first $1 of the distributable income of the trust for the year to Japp, and the balance to Arthur. The trust deed equates distributable income with s.95 taxable 'net income'. Japp and Arthur are both Australian residents for tax purposes. What is the outcome?

The resolutions are neither effective to stream to Japp the capital gain on the vested parcel shares nor to stream the franked dividends to Arthur.

In relation to a capital gain where there are no sale proceeds, the ATO does not accept that the beneficiary who receives the benefit of the asset on vesting has received or is entitled to receive the net financial benefit attributable to the capital gain, and therefore that the beneficiary is specifically entitled to the capital gain. The reasoning is that no beneficiary or trustee can be specifically entitled to a notional capital gain (a market value substitution gain), so notional capital gains are taxable proportionately to the beneficiaries who received Div 6E trust income.

The position would have been different had the trustee caused Japp to be absolutely entitled to those shares first before transferring the shares to Japp, e.g. by declaring a sub-trust for those shares in favour of Japp, as the ATO accepts streaming can apply where CGT event E5 applies.

In relation to the franked dividends, as the resolutions did not refer specifically to the franked dividends, and as they are not included in Div 6E income of the trust estate, the resolutions were not effective to cause any beneficiary to be specifically entitled to those franked dividends.

Keeping in mind that Div 6E trust income includes only the $1 interest income and $99 unfranked dividends (totalling $100) as any franked dividends and capital gains must be excluded irrespective of whether they have been streamed, the beneficiaries' proportions are:

> *Japp – 1 / 100 = 1%*
>
> *Arthur – 99 / 100 = 99%*

Applying the above proportions requires the following amounts to be included in the assessable income of each beneficiary:

> *Japp – 1% of all categories of taxable income – the $1 interest income, the $99 unfranked dividends, the $70 of franked dividends, $30 of franking credits and the $150 net (discounted) capital gain. 1% x $350 = $3.50.*
>
> *Arthur – 99% x $350 = $346.50.*

It may be noted that for trust law purposes, Japp is only entitled to receive an extra $1 from the trust. Arthur is entitled to receive an amount equal to the balance totalling $349 ($70 franked dividend plus $30 franking credits plus $99 unfranked dividends plus $150 net (discounted) capital gain).

However, the actual funds available to the trustee from current year income to pay these amounts is only $170 ($1 interest plus $99 unfranked dividends plus $70 franked dividends), given there was only a market value substitution capital gain.

This means when the beneficiaries demand payment of their trust entitlements, the trustee will need to resort to corpus (if available) to pay the shortfall of $180 ($350 minus $170). This shortfall arises as the trust deed equates distributable income with s.95 taxable 'net income'

Examples of Non-Tax Opportunities Post-Bamford and Streaming

Div 6 and the proportionate approach, even after the streaming amendments, can be hard on beneficiaries, as they can be assessed on amounts they never receive. However, modified Div 6 can still often be used to gain non-tax advantages for trust assets and beneficiaries, as illustrated by the examples below.

Where a beneficiary is in trouble with creditors, or with a spouse in the family court, then rather than stream a capital gain to the beneficiary, is there a way to keep the bulk of the money in the trust where it can remain protected, but still allow the beneficiary to be assessed at their marginal rate on the capital gain, accessing the CGT 50% general discount?

Similarly, if you want to retain funds in a trust rather than create UPEs in favour of a corporate beneficiary (with associated exposure to Div 7A when trying to access those funds back from the company), then rather than stream franked dividends to the corporate beneficiary, is there another approach that may allow the bulk of the dividends to be retained in the trust, but still make the dividend assessable to the corporate beneficiary?

Example 6

Miss Lemon Trust has a portfolio of Australian shares, which generates franked dividends of $700k. There is also $1k interest from a bank account. The trust deed defines "income" as s.95 taxable income, but in accordance with a power conferred on the trustee, it has been redefined, consistent with Div 6E and the streaming amendments, to exclude capital gains, franked dividends and franking credits. (Alternatively, "income" is defined as income according to ordinary concepts less franked dividends).

Based on that definition, the distributable income comprises $1k interest only. The first $1 of distributed income is appointed to Felicity. The balance ($999) is distributed to a corporate beneficiary, Whitehaven Pty Ltd.

What is the outcome? The taxable income includes the interest income of $1k plus the franked dividends of $700k plus franking credits of $300k, and totals $1,001,000. As the resolutions are not effective to stream the franked dividends, no beneficiary is specifically entitled to them.

Applying the proportionate approach, as Felicity is Div 6E presently entitled to 1/1000th of the Div 6E distributable income, she is assessed on 1/1000th of the interest income ($1,000 / 1000 = $1), 1/1000th of the franked dividends ($700k / 1000 = $700) and 1/1000th of the franking credits ($300k / 1000 = $300). Her total assessable income from the trust is therefore $1,001. After applying her marginal tax rate to that amount, a franking credit of $300 applies to reduce the assessed tax, or generate a tax refund if her effective marginal rate is below 30%. Remember, she is only entitled to receive $1 from the trust.

As Whitehaven Pty Ltd is Div 6E presently entitled to 999/1000th of the Div 6E distributable income, it is assessed on $999 of interest income from the trust. It must also include $699,300 of the franked dividends and $299,700 of the franking credits in its assessable income, however as a result of the franking credits, this means no tax is payable on the franked dividends or the franking credits. It will be taxed at 30% on the $999 of interest income that it receives. It has a tax bill of $299.70.

What advantage has been gained by not streaming the franked dividends? It is not a tax advantage. Under trust law, based on the definition of distributable income (limited to the interest income of $1k, consistent with 'Div 6E income of the trust estate'), only $1k of interest income needs to be paid out of the trust. $1 passes to Felicity. $999 passes to Whitehaven. All of the dividends can be retained in the trust, as an addition to the trust fund, where it is protected from beneficiary risk and can be reinvested to generate additional income in future years. Accordingly, the trust fund can grow without creating UPEs and without requiring a Div 7A loan or other compliant arrangement back from the company. If money needs to be taken from this trust for other uses in future years, it may be drawn in favour of Felicity or another beneficiary as a tax-free distribution of corpus.

<u>Example 7</u>

Roger Ackroyd Trust has $10k rental income and $90k taxable (discounted) net capital gain (similar to Example 1). The trust deed defines "income" as income according to ordinary concepts. The rental income is appointed to Flora. The net capital gain is retained in the trust. Under the proportionate approach, Flora has received 100% of the ordinary income and therefore 100% of the Div 6E income of the trust estate (i.e. $10k rental income) so is taxable on 100% of the net income of the trust ($100k taxable income), which included the $90k net capital gain. Flora will be taxed on the rental income and net capital gain even though the capital gain is retained in the trust.

The outcome for Flora is the same as would have occurred prior to the 2011 streaming amendments. Flora, as a matter of trust law, only has a right to require the trustee to pay her $10k from the trust income. This means Flora would have to pay any tax at her marginal rate on $100k taxable income of the trust and would have to resort to her own savings or other sources to do so, unless the trustee also resolves in its discretion to distribute a further amount from the trust (e.g. from non-taxable corpus / proceeds of sale of the asset). However, a top up distribution to Flora from corpus may not be possible. It depends on whether Flora is a capital beneficiary and whether the trustee has the power to distribute capital prior to the vesting day.

What advantage has been achieved by not streaming to Flora? It's not a tax advantage. By keeping the bulk of the proceeds of sale of the asset within the trust, it will be protected against beneficiary level risk. For example, if Flora was being pursued personally by creditors, why distribute any of the net proceeds of sale to her? It is true that if the capital gain was instead streamed to Flora, she could gift some of the proceeds back to the trust, after paying the tax. But that would still give her creditors recourse to those proceeds. If she went bankrupt, such a gift would allow the bankruptcy claw back provisions to be triggered.

As a variation on this scenario, let's assume the ATO audits the tax return and discovers the trustee made an error by allocating too many expenses to the asset's cost base which should have been allocated against the rental income, understating the capital gain and overstating the net rental income. What was before a positive amount of ordinary income is actually now a loss. So now no beneficiary is presently entitled to income of the trust. As a result, the trustee is assessed on the capital gain (grossed up amount of $180k, as the CGT 50% general discount is denied) at 47% under s.99A.

There could be many other reasons why the trustee may be assessed under s.99A on a capital gain rather than the beneficiary being assessed under s.97 (as modified by the streaming rules). For example, what if Flora decided she did not want the CGT bill so disclaims her entitlement to receive $10k from the trust?

Trust Resettlement

There may be situations where changes to a trust result in the creation of a new trust (a resettlement). Where a resettlement arises, the new trust may exist independently of the original trust or, alternatively, the original trust may cease to exist.

What constitutes a "resettlement" is a very important issue, for in circumstances where there is a resettlement, the tax consequences for the trust (and therefore the beneficiaries of the trust to whom any tax liability may be assessed) can be potentially very serious. For example:

(a) tax losses and franking credits held within the trust structure will be lost;
(b) trust assets will be deemed to have been realised by the trustee (resulting in capital gains under CGT event E1 or other tax liabilities); and
(c) the beneficiaries' interests in the trust will end.

Importantly, any latent capital gains are included in the determination of the trust's net capital gain under s 102-5 and may potentially be assessed to either the beneficiaries or the trustee if these gains are included in the net income of the trust. As resettlement will give rise to notional capital gains (market value substitution gains), it won't be possible to stream those gains to beneficiaries, and so they are at increased risk of s.99A taxation for the trustee at top marginal rate and without the benefit of the CGT 50% general discount.

When does a resettlement arise?

There is much case law on whether a resettlement arises in the context of stamp duty (where there is a transfer of dutiable property).[42] These cases indicate that a new settlement is created when:

1. the changes to the trust amount to a new charter of rights and obligations; or
2. different equitable interests to those which existed under the pre-existing trust are created in the trust fund.

In *CSR (Vic) v Lam & Kym Pty Ltd*,[43] the Victorian Court of Appeal held that a new trust arose when the trustee of a discretionary trust declared that the trust's assets would no longer be available to some of the discretionary beneficiaries.

In a test case on resettlements for income tax purposes, the High Court in *FCT v Commercial Nominees of Australia Ltd*[44] considered whether a superannuation fund was entitled to utilise prior year losses following amendments to its trust deed (including the appointment of a new trustee, a new set of rules and a change in the nature of benefits from defined to accumulation). The High Court held that a resettlement did not arise because:

(a) the amendments were authorised by the trust deed (which contained wide powers of amendment);
(b) the trusts under which the superannuation fund operated were still constituted by the original trust deed (as varied);
(c) the trust property and the fund members did not change; and
(d) the superannuation industry regulatory authority treated the fund as a continuing fund, both before and after the amendments.

According to the High Court, there are 3 main indicators of continuity of a superannuation entity for income tax purposes:

1. the constitution of the trust under which the fund operates;
2. the trust property; and
3. membership.

In an ATO document *Creation of a new trust – Statement of Principles*, the Commissioner took the view that the High Court's decision in *Commercial Nominees* was restricted to superannuation funds (even though it was a test case on resettlements).

In *Clark v FCT*,[45] however, the judge at first instance (Greenwood J) said the High Court's 3 indicia of continuity apply equally for the purposes of Div 6 (e.g. to determine the availability of allowable deductions or the application of previously unapplied capital losses). His Honour also considered the decision of the Full Federal Court in *Commercial Nominees*, before concluding (at para 100):

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[42] See e.g. *Commissioner of Stamp Duties (NSW) v Buckle* (1998) 192 CLR 226; and *Gartside and Anor v Inland Revenue Commissioners* [1968] 1 All ER 121

[43] [2004] VSCA 204

[44] [2001] HCA 33

[45] [2009] FCA 1401

> *It follows that if some degree of continuity of trust property is made out and continuity in the regime of trust obligations is established, there will be sufficient identity of taxpayer in the sense that the hypothetical representative trustee taxpayer on behalf of the trust estate that incurred the loss is the hypothetical taxpayer of the trust estate that made the net capital gain.*

In *Clark*, a property development unit trust had accumulated losses of $3.9m (including unrealised net capital losses of $2.49m). The trust deed gave the trustee extensive powers of management and unitholders had the power to remove the trustee and appoint a new trustee.

The trust's controller (and unitholder) entered into joint venture arrangements with related companies to undertake property development projects through the trust (and to enable the controller to utilise the accumulated losses).

Various changes were made to the unit trust, including appointing a new trustee, extinguishing the former trustee's right of indemnity and a change in unit holdings. The sum of $1.8m was injected into the trust in return for the discharge of claims against the trust estate by the related companies.

In the Commissioner's view, these arrangements fundamentally changed the nature of the unit trust, such that the trust estate which made the capital losses was not the same trust estate which made a capital gain in a subsequent income year (through its property development projects).

Greenwood J held that the changes to the unit trust did not result in a break in continuity because the trust property and the trustee's interest in the trust estate were not fundamentally altered. In his Honour's view, the conditions leading to the former trustee's right of indemnity being extinguished were matters influencing the exercise of the power to replace the trustee.

The extinguishment was an element of enabling further contributions to be made to the trust fund, allowing the trustee to embark on property development projects (as it had done historically, but could not do because of the accumulated losses and the inability to raise capital or debt).

His Honour also rejected the Commissioner's submission that the appointment of the new trustee effected a change in those who controlled the discretionary power of application of the net income of the trust. Greenwood J said (at para 129) that a change in control in the exercise of the powers conferred on the trustee by the deed logically flows from a change of trustee.

Finally, his Honour found that although there was a change in ownership of the units in the trust, the interests of unitholders remained the same.

Consequently, because the trust estate that made the capital loss in an earlier income year was the same trust estate that made the capital gain in the relevant income year, the unapplied net capital losses of the trust were available to reduce the capital gain.

The Commissioner's appeal to the Full Federal Court was dismissed. In *FCT v Clark*,[46] a majority (Dowsett J dissenting) agreed with Greenwood J that a resettlement did not arise because:

1. the rights under the trust deed were unaffected by the arrangements (the exercise of those rights were the subject of the arrangements);
2. the former trustee's waiver of its right of indemnity was irrelevant (Dowsett J agreed with this point); and
3. crucially, there was no severance in the continuum of trust property and membership.

The majority, Edmonds and Gordon JJ, said (at para 87):

[46] [2011] FCAFC 5

> *When the High Court in Commercial Nominees spoke of trust property and membership as providing two of the indicia for the continued existence of the eligible entity or trust estate, the Court was not suggesting that there had to be a strict or even partial identity of property for the first and objects for the second. It was speaking more generally: that there had to be a continuum of property and membership, which could be identified at any time, even if different from time to time; and without severance of one or both leading to the termination of the trust in question. In the present case, the Commissioner never contended, nor on the evidence could he, that there was a severance in the continuum of trust property and objects of the CU Trust. Their identity changed from time to time, but not their continuum.*

In dissenting on the resettlement issue, Dowsett J concluded that the trust estate which incurred the losses was "gone". The affairs of the trust had effectively been wound up by disposing of all assets and resolving all outstanding liabilities. His Honour reasoned (at para 45) that "where a trust has been effectively deprived of all assets and re-endowed, I see no way in which it can be said that the original trust estate has continued".

ATO position before April 2012

In *Creation of a new trust – Statement of Principles* (issued in 1999 and updated in August 2001) and in Trust Resettlements – AIFRS Related Amendments to Trust Deeds (September 2007), the Commissioner took the view that a new trust would arise if there was a change in the essential nature and character of the original trust relationship. The Statement of Principles listed the following as some of the changes which raised the question of whether a new trust had been created:

(a) any change in beneficial interests in trust property;
(b) a new class of beneficial interest is introduced or altered;
(c) a possible redefinition of the beneficiary class. The ATO considered that changes amounting to a redefinition of the membership class or classes would terminate the original trust, whereas changes in the membership of a continuing class were consistent with a continuing trust;
(d) variations in the terms of the trust or the rights or obligations of the trustee;
(e) changes in the nature or features of trust property, including additions and depletion of trust property;
(f) a change in the trust's termination date;
(g) a change to the trust that is not contemplated by the terms of the original trust; and/or
(h) the merger of 2 or more trusts or a splitting of a trust into 2 or more trusts.

Whether there was a resettlement would depend, among other things, on the terms of the original trust and the trustee's powers. The settlor's original intentions were also relevant. For example, if a trust was established for the express purpose of holding a particular asset, the replacement of that asset with other assets may indicate the creation of a new trust.

In a *Decision Impact Statement on FCT v Bamford*, the ATO noted that, where a trust deed is amended to insert a definition of income (particularly if a re-characterisation or equalisation clause is inserted), the tax effect of the amendment would need to be determined in accordance with the Statement of Principles.

ATO position from April 2012

The Statement of Principles was withdrawn in April 2012, but only after the High Court had refused to grant the Commissioner special leave to appeal the decision in *FCT v Clark*.

In *Taxation Determination TD 2012/21*, the Commissioner acknowledged that, as a result of the Full Federal Court's decision in *FCT v Clark*, the approach set out in the Statement of Principles could not be sustained. The Commissioner now accepts that "continuity of trust is a function of whether the trust continues in existence under trust law in contradistinction to having terminated".

The determination states that CGT event E1 (creating a trust over a CGT asset by declaration or settlement) will not generally happen if the terms of a trust are changed pursuant to a valid exercise of a power contained in the trust's constituent document, or are varied with a court's approval. CGT event E2 (transferring a CGT asset to a trust) will also not occur. However, a CGT event will occur if the change:

- causes the existing trust to terminate and a new trust to arise for trust law purposes; or
- results in a particular asset being subject to a separate charter of rights and obligations such as to give rise to the conclusion that that asset has been settled on terms of a different trust.

In *Oswal v FCT*,[47] the trustee of a discretionary trust exercised a special power of "appointment" to make two beneficiaries (the trustee and his wife) absolutely entitled to part of the corpus of the trust (being certain shares in a related company). The Federal Court found that CGT event E1 occurred because the legal effect of the appointment was to create a separate trust over that part of the corpus for the absolute benefit of the beneficiaries. The Court dismissed the taxpayers' argument that the effect of the declaration was simply to establish a "separate fund of assets under the umbrella of the trust".

Proposed rewrite of trust laws and resettlements

The Gillard Government's 2012 policy options paper, *Taxing Trust Income – Options for Reform* makes the following remarks about changes to trusts deeds and possible transitional relief if the changes lead to a resettlement:

> *The Government is aware that decisions taken to change the taxation of trust income may lead users of trusts to alter their trust deeds. Such changes may lead to a resettlement of the trust estate … These issues will be considered further as part of the broader question of transitional relief when the final policy is settled by the Government. A number of factors will be relevant to determining whether relief might be appropriate, including, for example, the extent of any changes to the trust income tax provisions, and also whether those changes mandate or merely provide incentives to change trust deeds*

Trust splitting

Some practitioners turned to trust splitting after the ITAA was amended to remove the CGT exemption for trust cloning under s.104-55(b) and 104-60(b) with effect from 1 November 2008.[48]

Trust cloning involved transferring an asset from one trust to another trust where the beneficiaries and terms of both trusts were the same. Having regard to its impact on consolidated revenue, the trust cloning strategy was never popular with the ATO. Before the legislative amendment, the ATO tried to limit the exemption in *Taxation Ruling TR 2006/4* by taking a restrictive view of the requirements to effectively establish a trust that was the same as the original trust.

Interestingly, following introduction of the small business restructure rollover in Subdiv 328-G (which can apply to discretionary trusts) from 4 February 2016, some practitioners have rediscovered the trust cloning strategy in circumstances where:

a) the trust is a small business entity;

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[47] [2013] FCA 745

[48] See *Tax Laws Amendment (2009 Measures No. 6) Act 2010*

b) the assets transferred are "active assets";
c) the restructure is a "genuine"; and
d) the terms of both trusts are identical; or
e) both trusts appoint the same "test individual" under a Family Trust Election (FTE).

In relation to trust splitting, the ATO released draft *Taxation Determination TD 2018/D3* on 10 August 2018. In this draft determination, the ATO describes a trust splitting scenario, as follows, and then asserts that it would trigger CGT event E1:

- The trustee of an existing trust is removed as trustee of part/some of the trust assets and a new trustee is appointed to hold those assets.
- Control of the original trustee is changed such that control passes to a subset of the beneficiaries of the original trust. The new trustee is controlled by a different subset of beneficiaries.
- Different appointors are appointed for each trustee.
- The rights of indemnity of the trustees are segregated such that each trustee can only be indemnified out of the assets held by that trustee.
- The expectation is that the new trustee will exercise its powers in respect of the assets it holds independently of the original trustee to benefit the subset to the exclusion of others. The original trustee will also exercise its powers in respect of the assets held by it independently of the new trustee to benefit a different subset again to the exclusion of others. This is so whether the range of beneficiaries that can benefit from particular assets is expressly limited.
- The rights, obligations and powers of the trustees and beneficiaries remain governed by the one deed.
- The original trustee and new trustee keep separate books of account.

This draft determination has drawn criticism by various practitioners and professional bodies.

For example:[49]

- The trust split arrangement described is not necessarily typical of such arrangements.
- The reasoning in the Draft TD could be applied more widely as it can be applied to any appointment of a new trustee who may exercise discretions in a different manner to the previous trustee.
- The references to rights of indemnity are not relevant. Those rights are personal to a trustee arising from the personal liability of that trustee. A trustee cannot have personal liability for the acts of another or arising from property held by another. It follows there is no right of indemnity in that case. If the original trustee waives its rights of indemnity over assets transferred to the separate trustee that is a personal matter.
- Once it is recognised there can be one trust, that is the same relationship or obligations in respect of two funds, the practical difficulties referred to in paragraph 28 of the Draft TD fall away.
- The fact that after taking into account the matters that the original and separate trustees are entitled or obliged to do, they may come to different decisions does not mean that the powers and discretions have different purposes, the purposes remain the same, the implementation of those purposes is what differs.
- The Draft TD relies on fallacious reasoning. It does not logically follow that if the trustees have power to benefit one beneficiary or one class of beneficiaries they do not have power to benefit any other beneficiary or class of beneficiaries. That must be so when the governing document expressly gives the trustee the power to exercise the discretion in favour of any one or more of the beneficiaries.
- Having regard to the broad range of necessary amendments to family trust deeds and trust structures that can arise out of changed family circumstances, the draft TD's

[49] Law Council of Australia submission dated 10 August 2018

identification of what constitutes a "trust split" and the examples which are given are more likely to cause confusion than provide certainty as to what is the intended application of the law.

By way of further example:[50]

> *"TD 2018/D3 draws some hard-line conclusions regarding the CGT consequences of trust splitting. However, the draft determination fails to offer legally sound explanations or provide sufficient case law authority to support those conclusions. In addition, the position put forward In TD 2018/D3 represents another "change in interpretation" by the ATO.*
>
> *Taxpayers who are considering a trust splitting arrangement should carefully consider whether a trust split arrangement is the best way to achieve their desired objectives.*
>
> *Finally, because the draft determination is proposed to have retrospective effect, taxpayers who have implemented trust splitting arrangements, and who have not obtained a favourable private ruling, should seek advice immediately."*

Trust Vesting

Once a trust has vested, the takers on vesting will be presently entitled to any income derived after the vesting date, usually in proportion to their vested interests in the property of the trust.

Where, in the income year in which a trust vests, different beneficiaries are presently entitled to the income of the trust estate before and after the vesting date, the ATO will accept an allocation of the trust income that is done on a "fair and reasonable" basis: *Taxation Ruling TR 2018/6*.

TR 2018/6 also states that a payment or other purported distribution after the vesting date will be void if it is inconsistent with the fixed interests of the "vested" beneficiaries. Further, the deemed present entitlement rules in ss 101 and 95A(1) will not apply to deem a beneficiary to be presently entitled where the trustee purports to make an appointment or payment that is inconsistent with the fixed interests of the takers on vesting.

Hancock v Rinehart is one of the highest profile trust cases in the last 5 years. At the centre of that case was a trust created by Lang Hancock known as the Hope Margaret Hancock Trust, named after his wife. It was created for the benefit of his grandchildren, the children of his only child Gina Rinehart, namely John and Bianca Hancock (from Gina's first marriage to Greg Heyward) and Ginia Rinehart and Hope Welker (from Gina's second marriage to Frank Rinehart). Gina became trustee of the trust when Lang died in 1992. By 2015 the trust had assets of about \$5b. Income of the trust comprised dividends from Hancock Prospecting Pty Ltd, between about \$1.5m and \$3.5m per year. The trust held 24% of the voting rights in Hancock Prospecting. Gina herself held the remaining 76% of those rights. The trust had a vesting date of 6 September 2011, coinciding with the youngest grandchild's 25th birthday.

Three days before the trust was to come to an end on 3 September 2011, Gina wrote a letter to her children, the beneficiaries of the trust. She wrote that the trust's tax advisors, PWC had advised that much CGT would be payable when the trust ceased to exist, that each of the beneficiaries would likely be bankrupted by the tax bill, and that the shares held by the trust could not be sold to a non-Hancock family member or mortgaged.

She wrote that these consequences could be averted by extending the life of the trust, but she would only do that if those beneficiaries, her children, agreed not to query or challenge any act or by of her in relation to the trust, and agreed that any partners or spouses would be excluded from claiming on the assets of the trust.

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[50] Andrew Henshaw & Rosalind Li, "Trust splitting: the ATO's controversial new TD 2018/D3", *Taxation in Australia*, October 2018, Vol 53(4), p.203

Brereton J, in the Supreme Court of NSW, noted that ultimately it was established that there was no such advice in respect of CGT, and whilst that it was not entirely clear, the advice that had been obtained suggested that CGT would not in fact be payable when the trust ceased to exist.

The CFO of Hancock Prospecting, Mr Newby, told one of the children, Bianca, that she would have a tax liability of $142 million dollars if the trust finished on 6 September 2011.

The day after the letter, on 4 September, Gina Rinehart extended the trust until 1 July 2068, an additional 57 years. She did not tell the children of this at that time.

While the litigation culminated in the replacement of Gina with Bianca as trustee, the question of interest from a tax point of view is why it would have escaped CGT? Was it because the vesting day had been extended?

If the vesting day is extended, it is clear that any taxing event that may arise from the trust vesting is deferred. However, is it still possible to escape CGT when the vesting day arrives, e.g. if it had not been extended?

On the vesting day, the trustee holds the trust property for the absolute benefit of those beneficiaries specified as the takers on vesting.

In TR 2018/6 on trust vesting, the ATO states that CGT event E1 "need not happen merely because a trust has vested". The Commissioner accepts that vesting does not, of itself, cause a trust to come to an end and settle property on the terms of a new trust.

However, the Ruling indicates that CGT event E1 could occur if the parties to a trust relationship subsequently act in a manner that results in a new trust being created by declaration or settlement.[51]

According to the ATO in TR 2018/6, the vesting of beneficial interests in a trust, even if described as a ‘Termination Date’, does not ordinarily cause the trust to come to an end, nor cause a new trust to arise. Vesting does not mean trust property must be transferred to the takers on vesting on the vesting date, or that the trust must be wound up either immediately or within a reasonable period (although the deed may require these events to occur after vesting). Further, where a trustee continues to hold property for takers on vesting, the property is held on the same trust as existed pre-vesting; albeit the nature of the trust relationship changes.

Determining whether or not a CGT event happens on vesting requires a close consideration of the deed. This will include consideration of the effect of vesting on the beneficial interests in the trust, and the nature of the property held on trust. It may be the case that no CGT event happens by reason alone of the trust’s vesting. But events occurring post-vesting may cause a CGT event to happen subsequently.

The vesting of a trust may result in the takers on vesting becoming absolutely entitled as against the trustee to CGT assets of the trust, depending on the particular interests of the takers on vesting.

Having regard to the findings in the reported decision in the *Hancock v Rinehart* case, many believe that Ms Rinehart successfully obtained a private ruling from the ATO in relation to whether there were any CGT consequences for the trust vesting when Ginia turned 25.

While it cannot be certain, it appears that private ruling authorisation no. 1012254771092 relates to the Rinehart matter. That private ruling examined whether CGT event E5 occurred on the vesting of a trust.

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[51] See *TR 2018/6*, example 4

CGT event E5 is said to occur when a beneficiary becomes 'absolutely entitled' to a CGT asset of trust as against the trustee.

CGT event E5 happens if a beneficiary becomes absolutely entitled to a CGT asset of a trust (except a unit trust or a trust to which Division 128 applies) as against the trustee (disregarding any legal disability the beneficiary is under).

The time of the event is when the beneficiary becomes absolutely entitled to the asset.

The trustee makes a capital gain if the market value of the asset (at the time of the event) is more than its cost base. The trustee makes a capital loss if that market value is less than the asset's reduced cost base.

A capital gain or capital loss the trustee makes is disregarded if it acquired the asset before 20 September 1985.

The beneficiary makes a capital gain if the market value of the asset (at the time of the event) is more than the cost base of the beneficiary's interest in the trust capital to the extent it relates to the asset.

The beneficiary makes a capital loss if that market value is less than the reduced cost base of that beneficiary's interest in the trust capital to the extent it relates to the asset.

A capital gain or capital loss the beneficiary makes is disregarded if:

(a) the beneficiary acquired the CGT asset that is the interest (except by way of an assignment from another entity) for no expenditure; or
(b) the beneficiary acquired it before 20 September 1985; or
(c) all or part of the capital gain or capital loss the trustee makes from the CGT event is disregarded under Subdivision 118-B (about main residence).

The private ruling referred to above went on to explore in some detail the broad position that the ATO adopts in relation to CGT event E5 and absolute entitlement based on *Taxation Ruling TR 2004/D25*. The ATO confirmed that while *TR 2004/D25* remained in draft, so long as it is not withdrawn, it did represent its view of the law.

Based on an analysis of *TR 2004/D25*, the private ruling concluded that because no beneficiary was able to call for any one or more of the assets to be transferred to them (that is the shares were not "fungible"), they were not entitled to any assets as against the trustee, and therefore CGT event E5 did not occur on the vesting of the trust.

This outcome goes against the general position expressed in *TR 2004/D25*, that shares in a company are generally fungible. As such there must have been something specifically relating to the shares in Hancock Prospecting owned in the Hope Margaret Hancock Trust which meant that those shares were not considered fungible, perhaps relating to the restrictions against them being transferred.

Other tax rules

Certain categories of discretionary trust that satisfy relevant tests are eligible to make a family trust election (**FTE**), causing the trust to be considered a "family trust" for tax purposes.

Making an FTE in writing, in the approved form, enables the trust to access certain tax concessions, including:

1. Access to franking credits – the holding period rules allow the trustee and beneficiaries of a family trust that receives a franked dividend or franked non-share dividend to benefit from a franking credit concession. Unless the trustee of a non-fixed trust has elected for it to be a family trust, a beneficiary of the trust who does not have a vested and indefeasible interest in so much of the capital of the trust as is comprised by the shares giving rise to the dividends will not be a 'qualified person' for the purposes of

the holding period rule. Someone who is not a 'qualified person' is denied the benefit of the franking credits attached to dividends paid on shares, or interests in shares, acquired by trusts (other than widely held public share-trading trusts).

2. Trustee beneficiary reporting (**TBR**) rules – generally, these rules require the trustee of a closely held trust to advise the ATO of certain details. These are details about each trustee beneficiary that is presently entitled to a share of a tax preferred amount of the trust, or has included in its assessable income a share of the net income of the trust comprising an 'untaxed part'. This advice must be provided by the due date for lodgement of the closely held trust's tax return. Trusts that have made an FTE or an interposed entity election (**IEE**) (among others) are excluded from having to comply with the TBR rules.

3. Small business restructure roll-over – from 1 July 2016 small business entities can restructure their business including by moving assets into, or out of, a trust, company, partnership, or a combination, without adverse capital gains tax consequences. There are requirements that must be met in order to access the rollover. One of these is that there is no material change in the ultimate economic ownership of an asset. Special rules apply to a discretionary trust that has made an FTE.

4. The trust loss measures – a non-fixed trust that has a carried forward tax loss, or certain debt deductions, is unable to recoup the loss where it cannot not satisfy the required trust loss tests. However, by becoming a family trust, the trust is subject to concessional treatment and only one of the trust loss tests – the income injection test – applies, and only in a modified way.

5. A company loss tracing concession – the company loss provisions allow a company that has a non-fixed trust as a shareholder to benefit from a tracing concession where that non-fixed trust is a family trust. Broadly, the tracing concession applies so that where the relevant interests in a company are held by the trustee of a family trust, a single notional entity that is a person will be taken to own the interests. This means that there is no need to trace past the family trust.

While any kind of trust can elect to be a family trust, the need to pass the family control test restricts the choice to a trust that is not widely held and where a specific family effectively controls the trust.

A major drawback of making an FTE is that *family trust distribution tax* is payable at the top marginal rate plus Medicare levy when a distribution is made to a beneficiary of the trust that is not a member of the "family group" of the specified individual named in the FTE.

The following persons and entities are generally members of the "family group" of the individual specified in the FTE:

- the members of the specified individual's family;
- former members of the specified individual's family who are no longer members due to a breakdown in a marriage or relationship, or death (including former spouses, former widows/widowers and former stepchildren);
- family controlled or owned trusts, companies or partnerships;
- the family trust for which the FTE has been made;
- other family trusts with the same individual specified in their FTE;
- trusts, companies or partnerships that have made an IEE to become a member of the specified individual's family;
- trusts, companies or partnerships (other than non-fixed trusts) where certain members of the family group have fixed entitlements directly or indirectly, and for their own benefit, to all of the income and capital of the trust, company or partnership;

- deductible gift recipients in Australia; and
- bodies all of whose income is exempt from income tax.

Once an FTE has been made, it cannot be varied or revoked except in limited circumstances.

What reforms have been proposed?

Since 1950 there have been eight formal reviews of the tax system: the Spooner Committee, the Hulme Committee, the Ligertwood Committee, the Matthews Committee, the Asprey Committee, the Campbell Committee, and Ralph Committee and the Henry Committee. In addition there have been countless reviews by the Inspector General of Taxation, the National Audit Office and the Board of Taxation. In 1985 there was also a White Paper from Treasury, and in 1998 another one from Treasury, issued by Treasurer Peter Costello, called: "Not a New Tax, A New Tax System", colloquially known as the ANTS paper.

The Asprey report of 1975, led by NSW Appeals Court judge Ken Asprey, is generally regarded as the most successful, even though none of its recommendations had been implemented after a decade.

But since then, formal reviews have formed the basis of virtually all tax reform.

There is an argument that tax reviews should be conducted independently of government. At the moment the Government relies almost exclusively on Treasury for tax advice. The Board of Taxation has been prolific in its review of particular aspects and areas of our tax system.

Over the last few decades, various attempts have been made to rewrite Div 6.

In 1999, the Howard Government endorsed a proposal by the Ralph Committee Review of Business Taxation to tax trusts like companies. However, this proposal was abandoned in 2001, after the release of exposure draft legislation in relation to non-fixed trusts.

Under the *entity taxation reforms* recommended by the Ralph Review, it was proposed to tax trusts like companies at the 30% tax rate and to make all distributions of after taxed income fully franked, like dividends paid by a company. Income flowing through a trust would no longer retain its character in the hands of beneficiaries, and therefore the various categories of income, such as primary production income, dividends and capital gains, would lose their concessional tax treatment. It also proposed arbitrary distribution deeming rules, including the *profits first rule* and the *slice rule*.[52]

Under the *profits first rule*, any distributions made from a trust would be deemed to have been sourced first from profits already taxed, then untaxed profits, and then finally from contributed capital.

Under the *slice rule*, where a distribution arises from extinguishment of an ownership interest in an entity (e.g. a share buy-back), the member surrendering the interest would be treated as receiving in return a proportionate slice of contributed capital, taxed and untaxed profits relevant to their ownership interest.

On 11 October 2000, Peter Costello announced the release of Exposure Draft legislation to tax certain trusts like companies with effect from 1 July 2001. The exposure draft legislation was prepared following extensive consultation but provided the opportunity for further comment on the operation of the new arrangements.

This legislation was intended to implement the Government's policy of introducing greater consistency in the taxation of entities, which was announced in *A New Tax System*. The legislation proposed that that non fixed trusts were to be taxed like companies and was

[52] Chapter 19, *A Platform for Consultation*, Discussion Paper 2 – Building on a strong foundation, Vol 2, February 1999, Review of Business Taxation, Treasury.

intended to achieve the objective of greater consistency in the taxation of entities while minimising compliance and restructuring costs.

The Government received a great number of submissions to the exposure draft legislation which raised technical problems particularly in relation to distinguishing the source of different distributions, and valuation and compliance issues. The submissions together with a recommendation to not proceed from the Board of Taxation convinced the Government that the proposed legislation was "not workable".

Following the Treasurer's press release on 27 February 2001, the Board commenced a review focusing on 'tax abuse in the trust area'. The Board was able to conclude that no significant change was required to the status quo, therefore the next step of identifying 'principles which can protect legitimate small business and farming arrangements' became unnecessary.

The Board prepared its report on the Taxation of Discretionary Trusts and provided it to the Treasurer in November 2002. The report made four recommendations.

On 12 December 2002, Mr Costello announced the release of the Board's report Taxation of Discretionary Trusts. Upon recommendation from the Board, the Treasurer announced that the Government would legislate to introduce new provisions in place of Section 109UB dealing with distributions from trusts.

On 19 February 2004, the Government introduced legislation based on the Board's recommendation in *Tax Laws Amendment (2004 Measures No. 1) Bill 2004*. The amendments deemed certain transactions undertaken by a trustee of a trust estate to be an assessable dividend in the hands of a shareholder of a private company (or their associate), where:

- the private company is presently entitled to income of the trust but that income has not been paid; and
- the trustee distributes the underlying cash to a shareholder (or their associate) of the company in the form of a payment, loan, or forgiven debt.

The Bill received Royal Assent on 20 June 2004. Additional recommendations made by the Board did not require legislation.[53]

In 2008, the Board of Taxation was asked to review the tax arrangements applying to managed investment funds. In conducting the review, the Board was directed to consider whether any recommended changes could be applied to the tax arrangements for trusts in general. The Board was asked to develop options for reform with taxation outcomes that are broadly consistent with the following key policy principles:

- the tax treatment for beneficiaries deriving income from the trust should largely replicate the tax treatment for taxpayers as if they had derived the income directly;
- beneficiaries should be assessable on their share of the net income of a trust if it is paid or applied for their benefit, or they have a present right to call for immediate payment;
- the trustee should be taxed on the net income of the trust that is not assessable to beneficiaries; and
- trust losses should remain trapped in the trust, subject to limited special rules for their utilisation.

In its discussion paper on managed investment funds (released in October 2008), the Board of Taxation commented that ITAA does not encode a single coherent policy for the taxation of trusts and that there had been no systemic approach to align the tax laws with modern practice and the use of trusts as commercial vehicles.

[53] See http://taxboard.gov.au/consultation/taxation-of-discretionary-trusts/

In 2009, the Board of Taxation formally recommended that Div 6 be the subject of a wider review, in order to consider various options for determining tax liabilities, such as the distribution model (which would assess beneficiaries on a receipts basis) or the patch model (amending Div 6 to overcome the problems with its operation).

Dr Ken Henry's *Australia's Future Tax System* review also recommended that the trust rules be updated and rewritten to reduce complexity and uncertainty.

In 2010, the Gillard Government announced a public consultation process as the first step towards updating the trust income tax provisions and rewriting them into ITAA97.[54] It was initially proposed that the start date of the rewritten trust income tax provisions would be 1 July 2013. However, as an interim measure, amendments were introduced to allow streaming of capital gains and franked distributions to specified beneficiaries, with effect from the 2010-11 income year. The Gillard Government subsequently extended the proposed start date to 1 July 2014 and indicated that legislation would be released in mid-2013.[55]

However, no such legislation has yet been released. Following the change of government at the 2013 federal election, the Coalition continued to hold onto power at the two subsequent elections in 2016 and 2019. The current Government has not made any official announcements concerning the proposed rewrite of Div 6. However, the Abbott Government's March 2015 tax discussion paper, *Re:think*, did acknowledge the "longstanding problems with the legal framework for the taxation of trusts" and noted that while changes have been made to address some specific issues (i.e. the 2011 streaming measures), wider reform had not occurred and the underlying problems remained.

As part of the Government's proposal to rewrite Div 6, Treasury released the following papers:

- a discussion paper on how to better align the concepts of the "income" and "net income" of a trust estate, and to provide a legislative basis for streaming capital gains and franked distributions, released on 4 March 2011;
- a consultation paper, *Modernising the Taxation of Trust Income – Options for Reform*, released on 21 November 2011;
- a discussion paper on the definition of "fixed trust", *A More Workable Approach for Fixed Trusts*, released on 30 July 2012; and
- a policy options paper, *Taxing Trust Income – Options for Reform*, released on 24 October 2012.

The consultation paper, *Modernising the Taxation of Trust Income – Options for Reform* (November 2011) canvassed 3 models for reforming Div 6 – a "patch" model, a proportionate assessment model and an economic benefits model. During consultations, various concerns were raised about each of these models.

Under the **patch model**, the existing structure of Div 6 would be retained and would include a definition of "income of the trust estate" for tax purposes, with four options for the treatment of expenses:

1. prescription by legislation (especially for allocation against different classes of income);
2. codification of the common law principle for apportionment on a fair and reasonable basis;
3. maintaining the status quo - attribution on a fair and reasonable basis based on the relationship between the outlay and assessable income; or
4. inclusion in the definition of distributable income.

[54] See *Farmers Benefit with Changes to the Trust Law*, Media Release No 25 of Assistant Treasurer, Bill Shorten (16 December 2010)

[55] See Media Release No 80 of Assistant Treasurer, David Bradbury (30 July 2012).

The policy options paper, *Taxing Trust Income – Options for Reform* (October 2012) responded to feedback on the 2011 consultation paper, set out certain core features that any new model for taxing trust income should have, and further articulated the design of the economic benefits model and the proportionate assessment model.

The **economic benefits model** uses tax concepts to determine how different amounts should be taxed. Broadly, this model would assess beneficiaries on taxable amounts distributed or allocated to them, with the trustee assessed on any remaining taxable income.

The **proportionate assessment model** relies on general concepts of profit to determine tax outcomes. This model would assess beneficiaries on a proportionate share of the trust's taxable income equal to their proportionate share of the "trust profit" of the relevant class. As currently occurs, present entitlement would form the basis for attributing the trust profit or class amounts to beneficiaries.

The previous Government ruled out taxing trusts like companies.

The October 2012 options paper stated that any new model for taxing trust income should recognise trusts as primarily flow-through vehicles and should include features like:

(a) character retention – amounts flowing through a trust estate would retain the character they had in the trustee's hands when assessed to beneficiaries (unless another part of the tax law requires a different treatment);
(b) streaming – all amounts flowing through a trust estate could be steamed in a tax effective way to particular beneficiaries in accordance with the trust deed (subject to any other rules in the tax laws). This does not mean that the trustee would need a specific streaming power, but that the trustee must comply with the trust deed and trust law more generally;
(c) deductions should be allocated on a "fair and reasonable basis";
(d) the time for determining entitlements should be extended to 31 August (if the trust deed permits);
(e) beneficiaries should be taxed on capital gains made through the trust estate to the extent that they are entitled to gross capital gains (i.e. before any CGT concessions are applied, but after the application of relevant losses). Capital losses would only be available to reduce gross capital gains;
(f) the gross up for franking credits and foreign income would automatically attach to an entitlement or distribution;
(g) definite amendment periods – if the trust return indicates that the trustee is not liable to tax, this would be deemed to be a nil assessment, with the Commissioner's power to issue an amendment assessment limited to 2 or 4 years.

Integrity rules would continue to apply irrespective of which model is chosen.

The following table (adapted from the October 2012 policy options paper *Taxing Trust Income – Options for Reform*, p 5) compares the operation of current law with the proposed models.

	Current operation of Div 6 and streaming rules	**Proportionate assessment model**	**Economic benefits model**
What is a beneficiary assessed on?	A share of the trust's net income, based on the beneficiary's present entitlement to a share of the trust income	A share of the trust's taxable income, based on the beneficiary's present entitlement to a share of the trust profit or class amounts	Amounts distributed or allocated to the beneficiary that represent amounts of the trust's taxable income

What is the trustee assessed on?	Net income not assessed to beneficiaries	Taxable income not assessed to beneficiaries	Amounts representing taxable income not distributed or allocated to beneficiaries
What amounts can be streamed to beneficiaries?	Capital gains and franked distributions	All amounts	All amounts
What amounts retain their character when assessed to beneficiaries?	Capital gains and franked distributions	Classes of taxable income	Amounts representing the trust's taxable income
When does the trustee determine entitlements by?	30 June	31 August	31 August

Our current regime for taxing trusts relies on a system of voluntary lodgement of trust tax returns. Nothing in the proposed alternative models will change this. This is problematic and may be responsible for a significant loss of tax revenue as a result of tax avoidance and the failure to report. A recent study found that the interactions between the trust and tax laws were being manipulated and could be contributing to the sheltering of significant amounts of tax. At conservative levels this amount was estimated to be between $672 million and $1.2 billion pa. The study referred to the fact that chains of trusts and interlinking trusts were common, and speculated that this may reflect a deliberate intent to create a degree of opacity in relation to trust income. [56]

However, that is only one possible view and is open to criticism as a simplistic hypothesis. Many practitioners will appreciate that many clients legitimately use multiple discretionary trusts for asset protection reasons, to shelter passive investment assets from riskier assets, business risk or financial risk.

The same study highlighted the fact that there is no register of trusts in Australia, unlike other countries such as the UK, and suggested this was a key problem affecting the collection of tax on trust income in Australia. Putting in place a registry of trusts and taxing trust income at the trustee level, it was suggested, would overcome those inherent problems in our trust taxation regime.

In the lead up to the last federal election in May 2019, the Federal Labor Party led by Bill Shorten proposed to reform trust taxation by introducing a new 30% standard minimum rate of tax for discretionary trust distributions to adult beneficiaries. Despite the number of discretionary trusts in Australia, their policy paper *A Fair Go For Australia* estimated that 98% of taxpayers wouldn't be affected by their proposed reforms to discretionary trusts.

International comparisons

It is worth comparing how other countries currently tax trusts. Below I compare three other Commonwealth countries – the UK, Canada and New Zealand.

UK

In the UK, the trustees of discretionary trusts are responsible for paying tax on trust income.

Trustees are required to complete a trust and estate tax return.

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[56] See De Silva, A, Glover, J, Narayanan, V, Nguyen, T and Westberg, K 2018, *Current issues with trusts and the tax system*, ATO, Australia

The first £1,000 is taxed at the standard rate of 7.5% on dividend-type income and 20% on all other income. Trust income over £1,000 is taxed as follows. Dividend-type income is taxed at 38.1%. All other income is taxed at 45%. Trustees do not qualify for the dividend allowance. This means that trustees pay tax on all dividends depending on the tax band they fall within.[57]

If you're the beneficiary, then you might be able to claim some of the income tax back, depending on the type of trust and your income.

Canada

In Canada, the tax payable by an inter vivos trust is calculated at a flat rate of approximately 50% (combined federal and provincial tax) of its taxable income.

Income of a trust resident in Canada that is paid or payable to a beneficiary is generally deductible to the trustee in computing the taxable income of the trust and is included in the income of the beneficiary, Therefore, a trust may function as a conduit for tax purposes.

However, designated income of an inter vivos trust (i.e. income from carrying on business in Canada, income from holding Canadian real estate, income from resource properties and timber resource properties, and gains realized on dispositions of taxable Canadian property) that is paid or payable to a beneficiary can, in certain cases (e.g. when the trust has non-resident beneficiaries), be subject to a special tax in the trust at 36%.

This tax is deductible in computing the income of the trust, and resident beneficiaries obtain credit for their share of tax.

Non-resident beneficiaries do not obtain an income tax credit for their share of the tax and are also subject to a 25% withholding tax (15% if reduced by treaty) on distributions of designated trust income. This tax does not apply to testamentary and certain other trusts.

An unusual feature of Canadian tax law regarding trusts is that a trust is deemed to dispose of its assets every 21 years at their fair market values, subject to some exceptions. This deemed disposition could result in capital gains taxable to the trust itself. Upon the deemed disposition, the trust is also deemed to have reacquired the assets at the new values. The tax policy theory is that trusts should not be available as vehicles for undue deferment of capital gains taxes.

One potential result of the revaluation is that the trust could become liable to pay tax even though it did not receive proceeds from which to pay the tax. To ease the potential harshness of this situation, the tax may be paid in ten annual instalments with interest at prescribed rates.

Income of a trust resident in Canada that is paid or payable to a beneficiary (and is therefore deducted in computing the taxable income of the trust) is included in the income of the beneficiary. Income taxed in a trust (other than designated income) may generally flow to beneficiaries free of tax. Dividend tax credits and foreign tax credits may flow through the trust to the beneficiary. Net taxable capital gains that are allocated to Canadian-resident individual beneficiaries can be eligible for the capital gains exemption.

NZ

For income tax purposes, there are three distinct types of trust recognised in NZ: complying trusts (formerly qualifying trusts), foreign trusts and non-complying trusts (formerly non-qualifying trusts). This distinction is important, because the type of trust determines whether some distributions from a trust are taxable.

In relation to complying trusts, distributions to beneficiaries of the trust (other than distributions that are beneficiary income) will be exempt income in the hands of those beneficiaries.

[57] https://www.gov.uk/trusts-taxes/trusts-and-income-tax

Income derived by a trustee of a trust in NZ is taxed either as “beneficiary income” or “trustee income”.

Beneficiary income is income derived by the trustee of a trust that is vested absolutely in interest in a beneficiary in the income year when it was derived, or paid to a beneficiary during the income year or within the extended period allowed for in the NZ tax legislation.

Trustee income is all the annual gross income derived by the trustee of a trust in an income year that is assessable under s BD 1, other than income that is beneficiary income.

Trustee income is taxed in the hands of the trustee at a flat 33% tax rate.

A trustee may also be liable to pay provisional tax for the following year if its residual income tax at the end of an income year is NZD2,500 or more. Residual income tax is the amount of tax due at the end of the year, after deducting all tax credits the trustee can claim, but excluding provisional tax payments

Beneficiaries who are NZ residents are liable for NZ income tax on all their income, from any source in the world (at progressive rates up to 33%). Beneficiary income they receive from any trust will be taxable in NZ, at their normal income tax rates.

The trustee must pay tax on behalf of the beneficiary for the income allocated to them. The beneficiary can then claim a tax credit for the tax paid on their behalf. Beneficiaries are required to return all income received in their own Individual tax return.

Non-resident beneficiaries only have to pay NZ income tax on trust income derived from NZ. The trust must deduct non-resident withholding tax from any interest, dividends or royalties before they are received. This withholding tax is the final tax payable on the income. It will normally be possible to claim a credit for this tax in the country of residence. Other income, such as income from a rental property, will be subject to NZ income tax at the normal rates.

A complying trust is one which has been taxed in NZ on all its trustee income since the date it began. Complying trusts include:[58]

- trusts settled by NZ residents with NZ trustees;
- estates of people who were NZ residents when they died; and
- other trusts which have elected to become complying trusts.

A trust remains a complying trust if, since settlement of the trust, the trustees have satisfied all obligations in respect of its income tax liabilities.

A trust is not a complying trust if:

- the only trustee income is non-resident withholding income, or
- the trustees earn foreign-sourced income excluded from the meaning of assessable income.

If a trust ceases to meet the conditions for a complying trust in an income year, it will no longer be a complying trust - it will generally become a non-complying trust, for example, if the tax on a complying trust's trustee income is not paid, or if the trustees cease to be NZ residents.

A complying trust will not lose its complying status simply because one or more of the following apply, as there is no tax due on trustee income:

- the trust has no trustee income;
- the only trustee income is tax-exempt;

[58] My source of information for this and the succeeding paragraphs is https://www.offshoretrustsguide.com/report/new_zealand_taxation_of_trusts.asp.

- the trust's deductible expenses or losses exceed the trustee income, so there is no tax payable on the net trustee income.

A trust will be a foreign trust if none of its settlors have been resident in NZ since 17 December 1987 or the date the trust was first settled, whichever is the later.

A trust will cease to be a foreign trust if it makes any distribution after a settlor becomes a NZ resident, or if a NZ resident makes a settlement on the trust.

A non-complying trust is any trust that is neither a complying trust nor a foreign trust at the time it makes a distribution. It is generally a trust that has a resident settlor, has been established overseas with non-resident trustees, and has not been liable for NZ income tax since it was first settled. It also includes a trust where its trustee income has been liable to full NZ tax but the trustees have not paid the tax.

If a beneficiary ceases to be a NZ resident and then becomes a NZ resident again within 5 years, they must pay NZ income tax on any beneficiary income or taxable distributions received from a foreign or non-complying trust. In this situation, any beneficiary income or taxable distributions the beneficiary received while they were a non-resident will be taxable as such in the year in which the beneficiary again becomes a NZ resident.

If a beneficiary's residual income tax is NZD2,500 or more, the beneficiary will generally have to pay provisional tax for the following year. Residual income tax is the amount of tax due at the end of the year, after deducting all tax credits the beneficiary can claim, including tax paid by the trustee on the beneficiary's behalf, but excluding provisional tax payments.

The trustee is also liable for NZ income tax on income derived from outside NZ where:

- any settlor is resident in NZ at any time during the income year, or
- any settlor of an inter vivos or a testamentary trust died while they were resident in NZ, and a trustee is resident in NZ at any time during the income year.

There are two situations in which a trustee is not liable for income tax on trustee income derived from outside NZ. These apply where the trustee is resident outside NZ at all times during the income year and either:

- no settlement has been made on the trust since 17 December 1987; or
- the only settlements made on the trust were by settlors who were not resident in NZ at the time of settlement and who have not been residents in NZ since 17 December 1987.

If a trust was settled before 17 December 1987, and no settlement has been made on the trust since that date, the settlor is not liable for tax on trustee income unless they elect to pay tax on it.

If a settlement has been made on a trust since 17 December 1987, any settlor who is a resident in NZ at any time during the income year is liable for income tax on trustee income as agent of the trustee, subject to certain exceptions. If there is more than one NZ resident settlor, these settlors are jointly and severally liable for the tax on trustee income. This means that any or all of the NZ resident settlors are liable for this tax.

The NZ resident settlor will not be liable for the income tax on trustee income if any of these conditions are met:

- A trustee is resident in NZ at all times during the income year.
- The settlor (being a natural person, that is, not a company) was not a NZ resident at the time they made any settlement on the trust, unless the settlor elects to pay tax on trustee income.

- The settlor can show to Inland Revenue's satisfaction that their share of the trust's tax liability is excessive, taking into account the settlements on the trust made by all settlors.
- The trustee income is derived by the application of the accruals rules of the Income Tax Act to any amounts remitted by the settlor under any financial arrangement.

Conclusions and reflections

Discretionary trust taxation is more complex than ever after *Bamford* and the 2011 streaming amendments. The complex rules are beyond the comprehension of many practitioners and are of most benefit to a small group of tax advisers and lawyers who have mastered those rules, and their clients.

Top marginal rate taxation is the ultimate disincentive against trustees accumulating trust income, and the ultimate incentive for trustees to try and manipulate the tax position and outcomes of beneficiaries. The question remains ‘should we continue with such a feature as a matter of tax policy?’ If trustees distribute all income to beneficiaries in the year of derivation, with full conduit flow through treatment, then that would be fine. But as streaming is now denied to all but capital gains and franked distributions, it would seem that premise is now flawed.

The 2011 amendments were an interim measure only. While they are referred to as streaming amendments, they had the effect of closing a particular perceived loophole exposed by the *Bamford* decision, namely the ability of a trustee to manipulate tax outcomes by determining how to define the distributable income of the trust estate. After the amendments, capital gains and franked distributions must be excluded when working out the Div 6E distributable income of the trust estate, irrespective of whether those amounts are streamed or not.

There are still a range of scenarios of inherent unfairness under modified Div 6, where the burden of tax liability does not attach to the same persons or entities in whom or which the economic benefit of a distribution may pass. The law in this area is in need of reform and simplification if we want to see clearer and fairer outcomes for beneficiaries and a taxation regime of greater integrity, and also to achieve greater taxation revenue security for our Treasury and government.

As a starting point, our tax system should not unfairly discourage the retention of trust income by trustees compared with other forms of structure.

Perhaps as an initial step we should consider replacing top marginal rate taxation on retained trust income and move to a system that taxes trustees at a flat, non-punitive tax rate, similar to other Commonwealth countries.

Despite previous failed proposals, that initial step of itself is unlikely to attract voter opposition. In my view, this would also be an important first step to help provide greater certainty, fairness, transparency and accountability in the collection of tax on trust income in Australia.

Any income streamed to beneficiaries in respect of the year derived by the trustee should be assessed at the beneficiaries’ own respective tax rates (as is the case now) however such income should retain its character in the beneficiaries’ hands and be assessed on that basis. Streaming should be allowed for all categories of income and gains, subject to requiring a specific entitlement to the net financial benefit referable to the relevant income or gain.

If we are going to give any credence to streaming and conduit theory, it is worthwhile retaining the requirement under the 2011 amendments that a beneficiary must receive the economic benefit of the distribution being streamed. Unlike the current approach, beneficiaries should not be forced to be assessed arbitrarily on a proportionate blended share of all types of income (except capital gains and franked distributions that have already been effectively streamed).

Beneficiaries should be assessed on a quantum basis on any *unstreamed income* that they receive or are entitled to receive for the income year. Why should they be assessed (as under the current proportionate model) on amounts that they never receive or have a right to receive?

Trustees should be assessed at a flat, non-punitive rate (e.g. 30%) on any taxable income of the trust for the year to the extent that it exceeds the distributable income that beneficiaries have received or are entitled to receive. One might expect, however, that the more income of the year that can be streamed to beneficiaries, the less the trustee will be assessable on (by virtue of taxable income exceeding distributed income).

In relation to any after-tax profits that have been retained by the trustee (on which the trustee has already paid tax), it should also be possible for the trustee to stream or distribute those amounts to beneficiaries in later years, and for those beneficiaries in turn to obtain a credit for the tax already paid on those profits by the trustee. However, retained profits lose their original character when derived by the trustee. A credit system would provide a degree of trustee-beneficiary tax integration, similar to how companies and shareholders are taxed.

It is well and good to commission tax reviews recommending aspirational designs for reform. We have seen our fair share of such reviews over the past 3 or more decades. Any reform needs to be kept simple and be politically supported. People won't vote for it if they don't understand it.

If our last federal election is anything to go by, the average voter seems to only care about one thing when it comes to tax reform. Will they have to pay more tax? Keeping this in mind, it may be preferable for any party in power to go back to trying a more incremental and piecemeal approach to tax reform, whilst maintaining the discipline to keep edging towards the desired end result that we ultimately wish to achieve, informed and supported by independent research. However, you have to wonder. If the Treasury Secretary (e.g. Ken Henry) couldn't get any tax reform through Parliament, is there any reason at all why a bunch of lawyers, accountants and academics should think they have any hope?[59]

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[59] https://www.abc.net.au/news/2011-10-05/kohler-nothing-will-come-of-the-tax-forum/3299118