Australian Government

Improving the taxation of trust income

Discussion paper
March 2011

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CONSULTATION PROCESS

Request for feedback and comments

The Government seeks your feedback and comments on the issues outlined in this consultation paper. The information obtained through this process will inform the Government's approach on the way forward and also assist in meeting the requirements of the Office of Best Practice Regulation.

While submissions may be lodged electronically or by post, electronic lodgement is preferred. For accessibility reasons, please email responses in a Word or RTF format. An additional PDF version may also be submitted.

All information (including name and address details) contained in submissions will be made available to the public on the Treasury website, unless you indicate that you would like all or part of your submission to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain in confidence should provide this information marked as such in a separate attachment. A request made under the *Freedom of Information Act 1982* (Commonwealth) for a submission marked 'confidential' to be made available will be determined in accordance with that Act.

Closing date for submissions: 18 March 2011

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FOREWORD

On 16 December 2010, I announced that the Government would conduct a public consultation process as the first step towards updating the trust income tax provisions in Division 6 of Part III of *the Income Tax Assessment Act 1936* (ITAA 1936) and rewriting them into *the Income Tax Assessment Act 1997* (ITAA 1997).

As part of this process, I also announced that the Government would obtain advice from the Board of Taxation (the Board), on whether there are any issues with the current operation of the trust income tax provisions that must be addressed in this current tax year.

After considering the advice provided by the Board, I am very pleased to release this discussion paper which highlights two areas of the taxation of trust income that will be amended to ensure that businesses and individuals who use trusts to facilitate a variety of business and personal activities can continue to do so with confidence in the tax outcomes that apply to their circumstances.

The proposed changes canvassed in this paper will apply from the 2010-11 income year.

The Government is aware that although these changes will significantly reduce the anomalous outcomes that can occur under Division 6 of Part III of the ITAA 1936, they will not resolve all of the issues with the current operation of the trust income tax provisions. A separate discussion paper to be released in the coming months, will consider the broader issues for improving the taxation of trust income.

Consultation plays a valuable role in developing policy responses to changes in the tax law and I look forward to receiving the views of the community on these important interim reforms.

The Hon Bill Shorten MP
Assistant Treasurer and Minister for Financial Services and Superannuation

1 BACKGROUND

1.1 PURPOSE OF THIS PAPER

On 16 December 2010, the Assistant Treasurer announced that the Government would conduct a public consultation process as the first step towards updating the trust income tax provisions in Division 6 of Part III of the *Income Tax Assessment Act 1936* (ITAA 1936) (Division 6) and rewriting them into the *Income Tax Assessment Act 1997* (ITAA 1997).

While the update and rewrite of the trust income tax provisions in Division 6 will eventually address the current issues with the operation of the trust income tax provisions, the Government is aware that there is a need for certainty in the interim.

After examining advice provided by the Board of Taxation (the Board), the Government has decided to amend the law to:

- better align the key concept of 'income of the trust estate' (which has been interpreted to mean distributable income) with the tax law concept of 'net income of the trust estate' (taxable income), so as to reduce anomalous outcomes and opportunities to manipulate tax liabilities; and

- ensure that capital gains and franked distributions (including the attached franking credits) can be streamed to particular beneficiaries.

This paper examines the merits of the different approaches that could be adopted to amend the current tax law to achieve these outcomes. The Government is not suggesting that there should be any changes to the trust law.

The High Court has observed that, whatever interpretation of Division 6 is adopted, anomalous results can occur as a result of differences between distributable income and taxable income.[1]

The Government is aware that the approaches canvassed in this paper may not correct every anomalous outcome that can occur as a result of the application of Division 6. Without more fundamental reforms — which will be considered as part of the broader update and rewrite of Division 6 — it will be possible to show examples that lead to anomalous outcomes under any of the interim approaches.

The Government has accepted the Board's advice that the issues highlighted in this paper must be addressed for this current tax year. This will ensure that the current uncertainties about streaming and opportunities for manipulation are addressed by amendments applying from the 2010-11 income year.

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1 *Commissioner of Taxation v Bamford*; *Bamford v Commissioner of Taxation* [2010] HCA 10 at 17.

1.2 CURRENT OPERATION OF DIVISION 6

Division 6 contains the current rules that govern how trusts are taxed. It requires the calculation of the 'net income of the trust estate' — broadly, the taxable income of the trust worked out as if the trustee were a resident taxpayer (under section 95 of the ITAA 1936). The taxable income of the trust is the total assessable income of the trust, including any net capital gains, less (with some exceptions) allowable deductions.

The amount calculated is then assessed either in the hands of a beneficiary or the trustee (or both, with credits preventing double taxation) having regard to the share of the trust's distributable income to which a beneficiary is presently entitled. The trust's distributable income is determined with reference to the relevant trust deed.

1.3 THE BAMFORD CASE

On 30 March 2010, the High Court handed down its decision in *Commissioner of Taxation v Bamford*[2] *(Bamford)*. In this case the Court considered the meaning of 'income of the trust estate' and the meaning of 'share' for the purposes of section 97 of the ITAA 1936. The Court clarified that:

- 'income of the trust estate' in section 97 of the ITAA 1936 refers to the distributable income of the trust as determined according to trust law; and
- 'that share' means 'proportion' such that once the share of the distributable income of the trust to which the beneficiary is presently entitled is determined, the beneficiary will be assessed on that same share of the trust's taxable income. This is referred to as the proportionate approach.

This decision has highlighted a number of longstanding problems with the taxation of trusts. In particular, it highlighted that the amounts on which a beneficiary is assessed do not always match the amounts that they are entitled to under trust law. This mismatch can result in unfair outcomes, as well as opportunities to manipulate tax liabilities.

The decision has also raised concerns about how the proportionate approach interacts with other areas of the tax law and, in particular, the extent to which income of a particular character derived by trustees (for example, capital gains or franked distributions) can be appointed or 'streamed' to specific beneficiaries[3].

2 *Commissioner of Taxation v Bamford*; *Bamford v Commissioner of Taxation* [2010] HCA 10.

3 See more recently the decision in *Colonial First State Investments Limited v Commissioner of Taxation* [2011] FCA 16 (*Colonial First State*) where Stone J observed in paragraphs 54 to 56 that to determine the amount included in a beneficiary's assessable income under subsection 97(1) of the ITAA 1936, the proportion of the income of the trust to which a beneficiary is presently entitled must be applied to 'the whole of the net income' of the trust.

1.4 WHAT IS DISTRIBUTABLE INCOME?

The concept of 'distributable income' is central to the operation of Division 6. The existence of distributable income is a precondition for the operation of section 97 of the ITAA 1936 as this section requires a beneficiary to be presently entitled to a share of the distributable income before it can operate.

Accordingly, if there is no distributable income, then any amount of taxable income the trust might have will be assessed to the trustee (generally at the highest marginal rate of tax). Determining the distributable income of a trust is therefore very important in determining the tax liabilities of the beneficiaries and the trustee of a trust.

The distributable income of a trust is broadly the income of the trust to which a beneficiary can be made presently entitled. This amount is calculated with reference to general trust law principles, having regard to the provisions of the relevant trust's deed and appropriate accounting principles.

Distributable income for the purposes of section 97 of the ITAA 1936 refers to trust income reduced by relevant expenses. This is the amount that is then available for distribution to beneficiaries. This interpretation was confirmed by Kiefel, Sundberg and Edmonds JJ in *Cajkusic v FC of T*[4] where they stated that:

> *The reference to 'income of a trust estate' in section 101 is a reference to the distributable net income; that is, the same income to which section 97 refers. If, as in the present case, there is no distributable net income then, even where the trust instrument gives the trustee a discretion in terms of the section, there is nothing in respect of which it can be exercised.*[5]

1.5 RELEVANCE OF THE TRUST DEED IN DETERMINING DISTRIBUTABLE INCOME

Before the High Court's decision in *Bamford* there were competing views about what role a trust's deed could have in determining the 'income of a trust estate'. One view was that distributable income referred to that which was income within the 'ordinary' meaning of income for tax purposes. Under this interpretation the terms of the trust deed were not relevant to the process of determining the trust's distributable income. Another view promoted was that distributable income actually referred to income available for distribution for trust law purposes, and hence should be determined with reference to the general trust law, including the terms of the relevant trust deed.

4 *Cajkusic v Commissioner of Taxation* [2006] FCAFC 164.
5 *Cajkusic v Commissioner of Taxation* [2006] FCAFC 164 at 34.

The High Court has now clarified that the phrase ‘income of the trust estate’ takes its trust law meaning with the consequence that the calculation of distributable income can be affected by the trust instrument, including a trustee properly exercising a power conferred on it by the deed. The Court noted that:

> *The very juxtaposition with section 97(1) of the defined expression ‘net income of the trust estate’ and the undefined expression ‘income of the trust estate’ suggests that the latter has a content found in the general law of trusts, upon which Division 6 then operates.*[6]

In addition the Court endorsed the reasoning of Sundberg J who had dealt with the same interpretative issue in Zeta Force Pty Ltd v Commissioner of Taxation[7] where he explained that:

> *The words 'income of the trust estate' in the opening part of section 97(1) refer to distributable income, that is to say income ascertained by the trustee according to appropriate accounting principles and the trust instrument. That the words have this meaning is confirmed by the use elsewhere in Division 6 of the contrasting expression 'net income of the trust estate'.*[8]

1.6 Differences between ‘distributable income’ and ‘taxable income’

One of the clear consequences of the Court’s decision in *Bamford* is that the distributable income and taxable income of a trust may differ significantly depending upon the operation of the relevant trust’s deed. Differences in these amounts can lead to unfair tax outcomes such as beneficiaries being taxed on amounts that they are not actually entitled to under trust law, as well as opportunities for taxpayers to manipulate their tax liabilities. Two examples of these unfair outcomes are illustrated in the examples below.

Example 1 — Income beneficiary assessed on amounts received by capital beneficiary

In the 2009-10 income year, the Wilson trust made a capital gain of $100 (not being a discount capital gain), and derived $10 ordinary income. The trust had no capital losses to apply against the capital gain and no expenses. The trust’s taxable income is therefore $110.

The Wilson Trust has two beneficiaries, Joanne and Steven. The trust deed provides that Joanne is entitled to all of the income received by the trust each year and Steven is entitled to the capital of the trust.

The expressions ‘income’ and ‘capital’ are not defined in the Wilson trust deed and would therefore take their ordinary meaning. The trust’s distributable income is therefore $10.

Under the proportionate approach, as Joanne is presently entitled to 100 per cent of the distributable income of the trust she will also be assessed on 100 per cent of the taxable income of the trust ($110). Joanne is assessed on the trust’s capital gain even though she has no entitlement to the amount under the deed.

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6 *Commissioner of Taxation v Bamford*; *Bamford v Commissioner of Taxation* [2010] HCA 10 at 36.
7 *Zeta Force Pty Ltd v Commissioner of Taxation* (1998) 84 FCR 70.
8 *Zeta Force Pty Ltd v Commissioner of Taxation* (1998) 84 FCR 70 at 74-75.

Steven, not being presently entitled to any share of the trust's distributable income, is not assessed on any amount of the trust's taxable income even though he is entitled to the whole of the capital gain.

Example 2— Exempt entity assessed on amount received by capital beneficiary

In the 2009-10 income year, the Daley trust generated $100,000 of rental income. The trust had no expenses. The trust deed does not define 'income' for the purposes of the trust deed. However, there is a reclassification clause that allows the trustee to treat receipts as income or capital of the trust at its discretion. The trustee determines to exercise its power to re-classify $95,000 of the rent receipts as capital and so the trust's distributable income is $5,000. The taxable income of the trust is $100,000.

The trustee exercises its discretion to appoint income and capital under the deed to beneficiaries within the class of discretionary objects. All of the distributable income is distributed to a charitable entity and an amount of capital representing $95,000 of the rent is distributed to Adam.

While there is some uncertainty about the way in which Division 6 would apply in this case, on one view, the charitable entity would be assessed on 100 per cent of the trust's taxable income of $100,000. However, as the charity is a tax exempt entity no tax would be payable. On that view, Adam would not be assessed on the $95,000 rental receipt that was distributed to him as capital.

1.7 Current operation of Subdivision 207-B — Franked distributions

If a corporate tax entity makes a franked distribution to one of its members, then as a general rule an amount equal to the franking credit on the distribution is included in the member's assessable income and the member is entitled to a tax offset equal to the same amount.

Subdivision 207-B of the ITAA 1997 (Subdivision 207-B) provides statutory rules for working out the tax effect, for a beneficiary, of a trustee receiving a franked distribution. It provides a code for working out the portion of the franking credits relating to a franked distribution that are to be included in the beneficiary's assessable income under section 207-35 of the ITAA 1997 (and in respect of which the beneficiary is entitled to a tax offset under section 207-45 of the ITAA 1997).

Focusing on the simple example of a franked distribution being made directly to a trustee and a share of the trust's taxable income being included under paragraph 97(1)(a) of the ITAA 1936 in the assessable income of a resident individual beneficiary not acting in a trustee capacity, the operation of Subdivision 207-B can be summarised as follows:

(a) the franking credit on the franked distribution received by the trustee is included in the assessable income of the trust (that is, the distribution is 'grossed-up') under subsection 207-35(1) of the ITAA 1997 and is, therefore, taken into account in working out the trust's taxable income;

(b) the beneficiary's 'share of the franked distribution' is calculated under item 3 of the table in subsection 207-55(3) of the ITAA 1997. Item 3, when read together with paragraph 207-50(3)(b) of the ITAA 1997, provides that the beneficiary's share of the franked distribution is 'so much' of the franked distribution of the trust 'as is taken into account in working out' the amount assessed to the beneficiary under section 97 of the ITAA 1936;

(c) the beneficiary's 'share of the franking credit' on the franked distribution is calculated under section 207-57 of the ITAA 1997;

(d) 'despite any provisions in Division 6' (including section 97 of the ITAA 1936), the beneficiary's 'share of the franking credit' is also included in the beneficiary's assessable income under subsection 207-35(3) of the ITAA 1997; and

(e) the beneficiary is entitled, subject to relevant integrity rules, to a tax offset also equal to its 'share of the franking credit' under section 207-45 of the ITAA 1997.

Subdivision 207-B also applies where, for example, franked distributions pass to beneficiaries through chains of trusts. In these cases, an entity's share of the franked distribution is determined with regard to the share of the distribution of each preceding entity in the chain through which the distribution flows, starting with the entity to which the distribution was directly made.

1.8 CURRENT OPERATION OF SUBDIVISION 115-C — TRUSTS WITH NET CAPITAL GAINS

Subdivision 115-C of the ITAA 1997 (Subdivision 115-C) sets out the rules for dealing with the taxable income of a trust that has a net capital gain.

Broadly, the effect of the Subdivision is to treat any capital gain included in the share of the trust's taxable income and assessed to a beneficiary as a capital gain made by the beneficiary. If the trustee reduced the capital gain by the capital gains tax (CGT) discount or the small business 50 per cent reduction, the beneficiary must gross-up the gain by the corresponding amount.

These 'extra' capital gains are then taken into account in working out the beneficiary's own net capital gain. That is, the beneficiary applies any capital losses or net capital losses against the capital gains. In respect of any extra capital gain remaining, the beneficiary can apply the appropriate CGT discount percentage to the gain (if it was a discount capital gain of the trust and the beneficiary is an individual, trust, or complying superannuation entity) and access the small business 50 per cent reduction (if the concession was applied by the trustee).

Subsection 115-215(6) of the ITAA 1997 provides a deduction for that part of a beneficiary's share of the taxable income of the trust that is treated as a capital gain of the beneficiary. This ensures that any capital gain component is not taxed twice.

2 Better aligning the concepts of distributable income and taxable income

This chapter highlights some of the ways in which trustees have sought to deal with the differences that arise between the distributable income and taxable income of trusts. It then discusses possible approaches that could be adopted to address the current mismatch between the concepts of distributable income and taxable income.

2.1 Existing methods of dealing with differences in distributable income and taxable income

Many trusts have sought to use specific provisions in their deeds to avoid the uncertainty that arises as a result of differences between distributable income and taxable income. These provisions generally take the form of an income equalisation clause or a clause that allows the trustee to re-classify receipts and outgoings as income or capital at their discretion.

2.1.1 Income equalisation clauses

Income equalisation clauses purport to equate the trust's distributable income with its taxable income. In some cases, the clauses operate by default in the event the trustee fails to determine a different methodology for calculating the trust's distributable income.

For trusts with such clauses, some amounts that would not ordinarily be considered income but are assessable (for example, a net capital gain) will form part of the trust's distributable income. Other amounts that might ordinarily be considered income but are not assessable (for example, ordinary income that is exempt or non-assessable non-exempt income) will not form part of the distributable income. In addition, expenses or outgoings that are not deductible will also be disregarded in working out the trust's distributable income.

Although these clauses appear to be effective in resolving discrepancies between a trust's distributable income and taxable income, there remains uncertainty as to whether these clauses deal effectively with amounts included in the assessable income of a trust that are not strictly income but rather represent notional tax amounts (for example franking credits). These amounts may not be considered to be distributable income, as they arguably do not represent accretions to the trust estate in the relevant income year that are available for distribution, and to which a beneficiary may become presently entitled. Stone J in *Colonial First State*[9] recently endorsed the view that notional amounts (such as franking credits) are not capable of funding an entitlement to income:

> *The respondent's written submissions explain its position convincingly. Among the many sources of uncertainty to which the Commissioner refers is 'a range of amounts' that may be included in section 95 income but which "are not capable of being recognised for accounting*

9 *Colonial First State Investments Limited v Commissioner of Taxation* [2011] FCA 16.

purposes, let alone founding an entitlement: e.g. franking credits, attributed foreign investment income, amounts included by operation of Pt IVA of the 1936 Act or deemed capital gains included by operation of the market substitution rule".[10]

2.1.2 Re-classification clauses

Trustees commonly rely on re-classification clauses to better match the distributable income of a trust with its taxable income.

Re-classification clauses, as the term suggests, give trustees the power to classify receipts and outgoings of the trust as being on income or capital account for the purposes of determining the distributable income of the trust. To be effective, the power of the trustee to re-classify amounts must be clearly expressed in the trust deed.

Any re-classification does not change how the taxation laws apply to these amounts. That is, a valid re-classification is only relevant to determining distributable income, not taxable income.

Whilst re-classification clauses can be used to correct otherwise unfair outcomes that may result from the proportionate approach, whereby the beneficiaries of trusts can be subject to tax on amounts that they are not entitled to under trust law, they can also be used to manipulate the tax liabilities of trust beneficiaries (as shown in example 2 above).

2.2 POSSIBLE APPROACHES TO BETTER ALIGN DISTRIBUTABLE INCOME AND TAXABLE INCOME

To ensure that those entities that enjoy the benefit of trust entitlements also bear the appropriate incidence of tax on those amounts, the Government will better align the trust law concept of 'distributable income' with the tax law concept of 'taxable income'.

Whilst the Government is aware that there are a number of different approaches that could be adopted to better align the trust law concept of 'distributable income' with the tax law concept of 'taxable income', defining the term 'income of the trust estate' (distributable income) for the purposes of Division 6 appears to be the most effective way to achieve this result.

Stakeholder comments are sought on the general approaches outlined below, as well as any other approaches that could be adopted to achieve the objective of better aligning these concepts.

The proposed changes will apply for the 2010-11 and later income years.

2.2.1 Defining distributable income using tax concepts

One way to craft a definition of distributable income may be simply to equate this amount with the 'net income of a trust estate' (as defined in section 95) — adjusted by relevant amounts (see below).

Regardless of how income and capital are defined for the purposes of a trust deed, the test of present entitlement would be applied by looking to see which beneficiaries are entitled to amounts

10 *Colonial First State Investments Limited v Commissioner of Taxation* [2011] FCA 16 at 88.

included in the (newly defined) distributable income of the trust for a year. Such a beneficiary could be an income or capital beneficiary under the deed.

Using the concept of taxable income as the basis for the definition of distributable income has a number of benefits, namely that it:

- will reduce the scope for beneficiaries to be subject to tax on amounts they are not entitled to under trust law;
- may avoid a trustee assessment where the trust makes a capital gain for an income year but has no other income; and
- builds on an existing concept, which would assist tax professionals and taxpayers to better adjust to this approach.

However, as this approach relies on adjusting the taxable income of the trust to calculate distributable income, it may result in increased complexity and compliance costs for trustees and beneficiaries of trusts.

In addition, it may also necessitate amendments to ensure that the trust's exempt and non-assessable non-exempt income is allocated appropriately amongst beneficiaries with entitlements to those amounts.

Furthermore, if the trust deed does not permit the trustee to distribute the whole of the amount that is taken to be 'distributable income' by virtue of the legislative definition (as either income or capital), this approach may mean there is an amount of income to which no beneficiary is presently entitled — and therefore an amount of taxable income assessed to the trustee.

The examples below highlight how applying a definition of distributable income, based on taxable income, would operate.

Example 3 — Income beneficiary assessed subject to a definition of distributable income based on taxable income

The Bennetts trust has two beneficiaries, Michael and Nerissa. Michael is entitled to all of the income of the trust and Nerissa is the only beneficiary entitled to capital. The trust deed does not define income so it does not include capital gains under the current law.

In the 2010-11 income year, the Bennetts trust received $5,000 in interest, $7,000 rental income and made a capital gain of $50,000 (not a discount capital gain). The trust had no expenses for the income year. In accordance with a power provided under the deed, the trustee advances capital of the trust representing the $50,000 capital gain to Nerissa.

Under the current law, the distributable income of the trust is $12,000. As Michael is the only beneficiary presently entitled to all of the trust's distributable income he would be assessed on the entire $62,000 of the trust's taxable income.

If 'income of the trust estate' were defined based on the trust's taxable income, Michael would remain presently entitled to $12,000 and would be assessed under the proportionate approach on an approximately 20 per cent share ($12,000/$62,000) of the trust's taxable income. Nerissa would be assessed on an approximately 80 per cent share ($50,000/$62,000) of the trust's taxable income.

Example 4 highlights how applying a definition of distributable income, based on taxable income, would operate in the circumstance outlined in example 2.

Example 4 — Exempt entity assessed subject to a definition of distributable income based on taxable income

In the 2010-11 income year, the Daley trust generated $100,000 of rental income. The trust had no expenses. The trust deed does not define 'income' for the purposes of the trust deed. However, there is a re-classification clause that allows the trustee to treat receipts as income or capital of the trust at its discretion. In the 2010-11 income year, the trustee determines to exercise its power to re-classify $95,000 of the rent receipts as capital and so the trust's distributable income is $5,000. The taxable income of the trust is $100,000.

The trustee exercises its discretion to appoint income and capital under the deed to beneficiaries within the class of discretionary objects. All of the distributable income is distributed to a charitable entity and an amount of capital representing $95,000 of the rent is distributed to Adam.

Under a definition of distributable income based on taxable income, the charity would be presently entitled to 5 per cent ($5,000/$100,000) of that income and would therefore be 'assessed' on $5,000 of the taxable income of the trust (though other provisions relating to the charity may operate to treat this amount as exempt or non-assessable non-exempt income).

Adam would be presently entitled to 95 per cent ($95,000/$100,000) of the distributable income and would be assessed on that same share of the taxable income of the trust.

What adjustments would need to be made?

When defining distributable income using tax concepts, the taxable income of a trust will need to be adjusted to reflect the actual amount available for distribution to the beneficiaries of the trust. These adjustments will need to take into account both notional income and expense amounts.

Consideration will therefore need to be given to whether amounts such as franking credits and deemed dividends should be treated as notional income and therefore excluded from distributable income. In addition, consideration will need to be given to whether amounts such as new business investment assets under Division 41 of the ITAA 1997 should be treated as notional expenses and disregarded in calculating distributable income.

Another adjustment that will need to be considered is whether the discount amount of a net capital gain should also be included in the distributable income of the trust. Arguably, including this amount in the definition of distributable income will allow the definition to better reflect each beneficiary's entitlement to the capital gains made by the trust, especially if it is possible under trust law to split the net and discount component of the gain.

The example below highlights the impact that including or excluding notional amounts such as franking credits in calculating a trust's distributable income can have on the tax liabilities of the trustee and beneficiaries of a trust.

Example 5 —definition of distributable income based on adjusted taxable income

The Frankie Trust is a discretionary trust. The trustee has a power to appoint the income of the trust at its absolute discretion to beneficiaries within a particular class. Income is not defined for the purposes of the trust deed and so it takes its ordinary meaning (in particular, it does not include franking credits attached to dividends received by the trust).

In the 2010-11 income year the trust received $10,000 in interest and a $70,000 franked dividend. The trust had no expenses for the income year. The taxable income of the trust estate is $110,000 (which includes a franking credit of $30,000).

The trustee resolves to appoint $40,000 of the trust income to each of Sam and Sarina. Under the current law, as they are both presently entitled to 50 per cent of the distributable income of the trust they will each be assessed on 50 per cent of the taxable income of the trust.

Under a definition of 'distributable income' based on taxable income (without adjustment for notional amounts) Sam and Sarina would be entitled to approximately 36.5 per cent ($40,000/$110,000) of the income of the trust estate. There would be approximately 27 per cent of the 'distributable income' of the trust to which no beneficiary was presently entitled and so the trustee would be assessed on a corresponding percentage of the taxable income of the trust ($30,000).

However if the 'distributable income' is adjusted to exclude the franking credits and thus equal $80,000 ($110,000 - $30,000), Sam and Sarina's entitlement will be to 100 per cent of the taxable income of the trust. As a result no amount would be assessable to the trustee.

2.2.2 Defining distributable income using accounting concepts

An alternative approach is to define the concept of distributable income with reference to accounting principles.

For example, 'distributable income' could be defined as equal to a trust's accounting profit for the relevant income year, as determined in accordance with generally accepted accounting principles (GAAPs).

Adopting this approach arguably has similar benefits as relying on a variation of the concept of 'taxable income'. That is, this approach:

- may reduce the scope for beneficiaries to be subject to tax on amounts they are not entitled to under trust law;
- builds on existing concepts that would be familiar to many tax professionals; and
- incorporates relevant expenses, meaning the defined concept of distributable income would reflect that income that is available for distribution.

However, as this approach will require all trustees to apply GAAPs it may also result in increased complexity and compliance costs as not all trustees currently apply these principles.

In addition, there is a significant risk that because this approach is based upon accounting principles there will remain the possibility of substantial mismatches between distributable income and taxable income.

2.2.3 Defining distributable income to specifically include capital gains

A further approach that could be adopted to better align the concept of distributable income with taxable income is to continue to allow the trust deed to determine what constitutes distributable income for tax purposes, so long as the trust's deed includes any capital gains made by the trust in its distributable income, for that income year. However, where the trust's deed does not include any capital gains made by the trust in its distributable income, these amounts could be included for tax purposes.

Whilst including capital gains in a trust's distributable income will reduce the scope for unfair tax outcomes, a specific anti-avoidance provision may also be required to ensure that the tax liabilities of beneficiaries of the trust cannot be manipulated. The purpose of the specific anti-avoidance provision would be to ensure that where the entitlements of the beneficiaries under the trust deed differ significantly from the amount of the taxable income of the trust that they are assessed on, there would be scope to examine and, if appropriate, alter the tax outcomes that flow from the application of the relevant trust deed.

The advantages of this approach are that it:

- will reduce the scope for beneficiaries of trusts to experience unfair outcomes due to the proportionate approach;
- avoids the complexity associated with adjusting the taxable income of the trust by notional income and expenses to reflect the actual amount that a trustee can legally distribute to beneficiaries of the trust; and
- will require less extensive legislative amendments.

However, by only adjusting the distributable income of a trust to include any capital gains, this approach may not fully reflect the actual amount that a trustee can legally distribute to the beneficiaries of the trust. In addition, it will not be able to address unfair tax outcomes that arise for reasons other than capital gains.

Generally, it is preferable for the operative provisions of the tax law to be sufficiently robust so that specific anti-avoidance rules are not required. This is because, where it is necessary to introduce a specific anti-avoidance rule, the interpretation of these often complex provisions can lead to increased uncertainty and compliance costs for affected taxpayers. Therefore, whilst this approach appears simpler than the approach proposed in section 2.2.1, the necessary inclusion of a specific anti-avoidance provision may limit its attractiveness.

3 ENABLING THE STREAMING OF FRANKED DISTRIBUTIONS AND NET CAPITAL GAINS

Under a flow-through approach to the taxation of trusts, certain amounts in the hands of the trustee are treated as retaining their character in the hands of beneficiaries. There are a number of rules in the tax law that specifically attribute tax characteristics to a beneficiary's share of the trust's taxable income to achieve this result.

However, the High Court's endorsement of the proportionate approach has raised concerns about how this approach interacts with the character attribution provisions in the tax law that assume, or provide for, amounts to have the same character in the hands of a beneficiary that they had in the hands of the trustee.

To resolve this uncertainty the Government will amend the current tax laws to ensure that Subdivision 207-B (which deals with distributions of franked dividends and entitlements to attached franking credits) and Subdivision 115-C (which deals with net capital gains of the trust) enable franked distributions and capital gains to be streamed for tax purposes.

3.1 ENABLING THE STREAMING OF FRANKED DISTRIBUTIONS WITH ATTACHED FRANKING CREDITS

Whilst the operation of Subdivision 207-B was not at issue in *Bamford*, as a result of the High Court's decision there is some uncertainty about how Subdivision 207-B interacts with Division 6, where a trustee has, in accordance with the deed, made a specific beneficiary presently entitled to a franked distribution.

One of the key uncertainties is how to calculate a beneficiary's share of the franked distribution.

Arguably, under the proportionate approach confirmed in *Bamford*, the amount of the distribution that is 'taken into account' in working out the (proportionate) share of taxable income of the trust on which the beneficiary is assessed is simply that same proportionate share of the distribution regardless of how the beneficiary's entitlements are expressed under the deed. This result would significantly limit the opportunities available to stream franked distributions through a trust.

There are however, a variety of features of Subdivision 207-B that point to an alternative interpretation.

Under this alternative interpretation, the beneficiary's actual entitlements under the deed are relevant to determining how much of the franked distribution was 'taken into account' in determining the share of the taxable income of the trust on which they are assessed. Therefore if, for example, a beneficiary is entitled under the trust's deed to all of the dividend income of the trust and for this reason is assessed on a share of the taxable income of the trust, then the entirety of the dividend income of the trust could be said to have been taken into account in working out that share of taxable income.

This approach appears to be more consistent with the intended operation of the franking credit rules. In particular, the example that follows subsection 207-35(3) of the ITAA 1997 provides support for this approach and highlights that this result is achieved by adjusting the assessable income of the beneficiaries who are not actually entitled to receive any of the franked distribution.[11] The example in the legislation is reproduced in Example 6.

Example 6 — Subsection 207-35(3)

A franked distribution of $70 is made to the trustee of a trust in an income year. The trust also has $100 of assessable income from other sources. Under subsection (1), the trust's assessable income includes an additional amount of $30 (which is the franking credit on the distribution). The trust has a net income of $200 for that income year.

There are two beneficiaries of the trust, P and Q, who are presently entitled to the trust's income. Under the trust deed, P is entitled to all of the franked distribution and Q is entitled to all other income.

The distribution flows indirectly to P (as P is entitled to a share of that net income and has a 100 per cent share of the distribution under section 207-55). P therefore has an amount of assessable income that is equal to its share of the distribution. Under this subsection, P's assessable income also includes the full amount of the franking credit (as P's share of the franking credit on the distribution is $30 under section 207-57). Q's share of the net income therefore does not include any of the franking credit.

A further uncertainty with the interaction of Subdivision 207-B and Division 6 is how the operation of Division 6 is modified by Subdivision 207-B given that the Subdivision is a 'code' for determining how franking credits attached to a distribution that flows through a trust are treated for tax purposes.

Absent of some modification of the normal operation of Division 6, the amount of a franking credit could arguably be brought to tax twice. The amount could be taxed once via Subdivision 207-B and once via the normal operation of Division 6 — on the basis that the franking credit forms part of the taxable income of the trust on which the beneficiaries are taxed under Division 6.

Subdivision 207-B attempts to deal with this issue via subsection 207-35(3) of the ITAA 1997, which states that, despite the operation of Divisions 5 and 6 of Part III of the ITAA 1936, the entity's assessable income for that year also includes so much of the franking credit amount as is equal to its share of the franking credit on the distribution. Whilst the reference to Division 6 in subsection 207-35(3) of the ITAA 1997 arguably deals with the issue of double taxation, the scope of these words (including precisely what modifications to the normal operation of Division 6 they demand) is not entirely clear.

11 The Explanatory Memorandum to *Tax Laws Amendment (2004 Measures No. 2) Act 2004* highlights at paragraph 10.27 that the assessable income of the beneficiaries will be adjusted to reflect their proportionate share of the franking credit based on their interest in the dividend.

3.1.1 Proposed legislative amendments

In order to provide certainty about the streaming of franked distributions, the Government will amend Subdivision 207-B to clarify how the operation of Division 6 is modified where a trustee receives a franked distribution with attached franking credits. Example 7 illustrates the intended operation of the law.

The proposed changes will apply for the 2010-11 and later income years.

Example 7 — Streaming of franked distributions and attached franking credits

In the 2010-11 income year, the Whitson family trust received a $70 fully franked dividend and $100 interest. The trust has no expenses for the income year.

The deed does not define the income of the trust. The trust's distributable income is $170 and the trust's taxable income is $200, taking into account the $30 franking credit on the franked dividend included in the trust's assessable income under subsection 207-35(1).

The trust has two beneficiaries of the trust, Belinda and Scott, neither of whom is under a legal disability.

The deed allows the trustee to identify separate classes of income and, in making any appointment of income to the beneficiaries, to specify the class of income from which that entitlement will be met. In exercising this power, the trustee resolves to distribute the dividend income ($70) to Belinda and the interest ($100) to Scott. Belinda and Scott have no other assessable income, gains or deductions.

Before any modifications to Division 6 made by Subdivision 207-B, applying the proportionate approach, the share of the taxable income on which Belinda is assessed under section 97 is $82 ((70/170) x $200) and the share on which Scott is assessed is $118 ((100/170) x $200).

Subdivision 207-B will operate to include the $30 franking credit in Belinda's assessable income under subsection 207-35 (3) of the ITAA 1997 as she was entitled, for trust law purposes, to 100 per cent of the dividend income: the whole of the dividend was taken into account in calculating the share of the taxable income of the trust on which she is assessed and therefore her share of the distribution (and so her share of the franking credit) is 100 per cent. Under section 207-45 of the ITAA 1997, Belinda will also be entitled to a tax offset of $30 (assuming the other requirements are met).

Scott will not include any amount of the franking credit in his assessable income under subsection 207-35(3) of the ITAA 1997 and, similarly, will not be entitled to any tax offsets in relation to the franking credit under section 207-45 of the ITAA 1997. This is because no amount of the dividend was taken into account in working the share of the trust's taxable income on which he is assessed.

To avoid double counting, Subdivision 207-B will modify the operation of Division 6 insofar as that Division would otherwise bring the franking credits to account in Belinda's and Scott's assessable income by reason of section 97 of the ITAA 1936. That is, the amount of the trust's taxable income that is assessed under Division 6 to Belinda and Scott will be reduced by $12 ((70/170) x $30) and $18) ((100/170) x $30) respectively.

In total, Belinda is therefore assessed on $100 (calculated as $82-$12+$30) including all of the franking credits. Scott is assessed on $100 (calculated as $118-$18+$0) and does not include any of the franking credits.

3.2 ENABLING THE STREAMING OF TRUST CAPITAL GAINS

The capital gains provisions contained in Subdivision 115-C of the ITAA 1997 were enacted to provide, among other matters, for appropriate amounts of the trust's taxable income that include a net capital gain to be treated as capital gains of presently entitled beneficiaries. This treatment allows beneficiaries to apply any capital losses they have against those extra capital gains and apply appropriate CGT concessions to any gain remaining.

Again, following the confirmation of the proportionate approach in *Bamford*, there is increased uncertainty as to how these provisions apply in situations where only certain beneficiaries are (made) entitled to amounts representing capital gains of the trust.

The intended operation of Subdivision 115-C is less certain than that of Subdivision 207-B due to the lack of explanatory guidance and the differences in legislative structure. In contrast to Subdivision 207-B, Subdivision 115-C starts with the amount of the trust's taxable income included in the beneficiary's assessable income and then asks how much of that amount is 'attributable to' a capital gain made by the trust.

Under the proportionate approach confirmed in *Bamford*, the amount included in a beneficiary's assessable income under section 97 of the ITAA 1936 arguably consists of an un-dissected proportionate share of the entirety of the trust's taxable income — that is, a 'blended' amount[12].

If so, the part of a beneficiary's share of the trust's taxable income that is attributable to a particular capital gain of the trust is their proportionate share of so much of that gain as is reflected in the trust's net capital gain, less their proportionate share of any deductible expenses related to that gain. On this view, a beneficiary may be treated as having an extra capital gain under Subdivision 115-C even though they have no entitlement to the capital gains of the trust under the trust's deed.

The following example highlights this interpretation of Subdivision 115-C.

Example 8 — Possible operation of Subdivision 115-C

In the 2009-10 income year, the Joseph trust generated $100 of ordinary income and made a $400 capital gain (the gain is a discount capital gain). The trust had no expenses. The taxable income of the trust is $300.

The trust deed defines income to include capital gains and so the distributable income of the trust is $500.

12 See more recently the decision in *Colonial First State Investments Limited v Commissioner of Taxation* [2011] FCA 16 (*Colonial First State*) where Stone J observed in paragraphs 54 to 56 that, to determine the amount included in a beneficiary's assessable income under subsection 97(1) of the ITAA 1936, the proportion of the income of the trust to which a beneficiary is presently entitled must be applied to 'the whole of the net income' of the trust.

In accordance with its powers under the deed, the trustee makes a determination to appoint all of the capital gains to Catherine and all other income to Aaron.

Each beneficiary is assessed under section 97 on their proportionate share of the taxable income of the trust calculated as follows:

Catherine:	((400/500) x \$300) = \$240
Aaron:	((100/500) x \$300) = \$60

On this view of the operation of Subdivision 115-C, Catherine's share of the taxable income of the trust that is attributable to the trust's capital gain is \$160 ((400/500) x \$200). Under Subdivision 115-C, she will be treated as if she made an extra capital gain of \$320. Catherine can apply any capital losses she has against this amount and reduce any remaining gain by the CGT discount in working out her own net capital gain. She is also entitled to a deduction of \$160 as this is the part of the amount already included in her assessable income under section 97 of the ITAA 1936 that is attributable to the capital gain made by the trustee.

On this view of the operation of Subdivision 115-C, of the \$60 included in Aaron's assessable income under section 97 of the ITAA 1936, \$40 will be taken to be attributable to the capital gain made by the trust. This is despite Aaron having no entitlement to benefit from the capital gains of the trust.

3.2.1 Proposed legislative amendments

To provide greater clarity, the Government will amend Subdivision 115-C to ensure that the amount of a trust's capital gain deemed to have been made by a beneficiary reflects that beneficiary's entitlement to that gain for trust law purposes. For example, the amended rules will have the result that a beneficiary who is not entitled to share in a capital gain of the trust under the deed will not by reason of Subdivision 115-C be taken to have an extra capital gain. As part of these amendments, the interaction between Subdivision 115-C and Division 6 will be clarified. The example below uses the same facts as Example 8 but illustrates the intended outcomes.

The proposed changes will apply for the 2010-11 income year and later income years.

Example 9 — Streaming of net capital gains

In the 2010-11 income year, the Joseph trust generated \$100 of ordinary income and made a \$400 capital gain (the gain is a discount capital gain). The trust has no expenses. The taxable income of the trust is \$300.

The trust deed defines income to include capital gains and so the distributable income of the trust for trust law purposes is \$500.

In accordance with its powers under the deed, the trustee makes a determination to appoint all of the capital gains to Catherine and all other income to Aaron.

Under the current law, the beneficiaries are assessed on each of their individual shares of the 'taxable income' as follows:

Catherine:	((400/500) x $300) = $240
Aaron:	((100/500) x $300) = $60

As per Example 8, on one view Catherine's share of the trust's taxable income includes a $160 share of the trust's net capital gain and an $80 share of the ordinary income of the trust. However, under the proposed changes to the law, Catherine will, based on her actual entitlement to all of the net capital gain made by the trust, include $200 as her trust gain for the purposes of Subdivision 115-C. She will then 'gross-up' this $200 under subsection 115-215 (3) of the ITAA 1997 and will be considered to have made an extra (discount) capital gain of $400.

Catherine can apply any capital losses she has against this amount and reduce any remaining gain by the CGT discount in working out her own net capital gain. She is also entitled to a deduction of $200 as this is the part of the amount already included in her assessable income under section 97 of the ITAA 1936 which is attributable to the capital gain made by the trustee.

Aaron on the other hand was not entitled to any part of the capital gain and so under the proposed changes to Subdivision 115-C it will not apply to treat him as having made any extra capital gains.

Adjustments will also be made to Division 6 to ensure that in this example in total Catherine is only assessed on $200 and Aaron is assessed on $100 under that Division.

QUESTIONS FOR CONSULTATION

The Government invites interested parties to provide comments and feedback on any aspect of this discussion paper, in particular:

- the general approaches outlined in Chapter 2 to define the concept of 'distributable income'; and
- the proposed methods outlined in Chapter 3 regarding the streaming of franked distributions and capital gains.

In addition to this, the Government would welcome comments on the questions below.

BETTER ALIGNING THE CONCEPTS OF DISTRIBUTABLE AND TAXABLE INCOME

1. If income of the trust estate is defined according to tax concepts should the gross capital gain be included in income or only the net capital gain (after applying available discounts)?

2. Should all notional amounts (for example receipts or expenses) be excluded from a definition of distributable income based on the concept of taxable income, or are there some notional amounts that should be included?

3. Would adjustments to the definition of distributable income also be needed where timing differences exist between the distributable income (as newly defined) and the trustee's calculation of 'income' pursuant to the terms of the trust deed? How could this be achieved?

4. Would the introduction of a specific anti-avoidance provision be effective to ensure that re-classification clauses could not be used to re-classify amounts of income or capital to obtain a tax benefit?

5. Even if a specific anti-avoidance provision were introduced to restrict the reclassification of trust amounts, would the distributable income of a trust still need to include any capital gains made by the trust to ensure that income beneficiaries are not taxed on capital gains that only benefit capital beneficiaries?

Streaming of certain trust amounts

6. Apart from clarifying the operation of subsection 207-35(3) of the ITAA 1997 (in particular the meaning of the words 'despite Division 6') are other changes needed to ensure that Subdivision 207-B operates appropriately?

7. Should Subdivision 115-C continue to apply after the application of Division 6 where there is a discrepancy between a beneficiary's entitlement to a capital gain included in the distributable income of the trust and the amount of the trust's net capital gain included in the beneficiary's assessable income?

8. Instead of looking to amounts assessed to beneficiaries under Division 6, should Subdivision 115-C instead look to the trust entitlements of the beneficiaries?

ABBREVIATIONS

The Board	Board of Taxation
Division 6	Division 6 of Part III of the *Income Tax Assessment Act 1936*
Subdivision 207-B	*Subdivision 207-B of the Income Tax Assessment Act 1997*
Subdivision 115-C	*Subdivision 115-C of the Income Tax Assessment Act 1997*
GAAP	Generally Accepted Accounting Principles
ITAA 1936	*Income Tax Assessment Act 1936*
ITAA 1997	*Income Tax Assessment Act 1997*