The Treasury

Improving the taxation of trust income

18 March 2011

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Improving the taxation of trust income

Introduction

Thank you for the opportunity to provide these comments and submissions in respect of the Discussion Paper – *Improving the taxation of trust income*. We consider that the reform of Division 6 is both necessary and important in providing certainty for taxpayers in relation to the income they derive through trusts. We consider the following principles are important in formulating any interim reforms for the taxation of trusts:

- a trust is a conduit relationship and should be treated as such for taxation purposes;
- the conduit nature of a trust should result in the income that flows through a trust retaining its character and any related tax attributes when taxed in the hands of an investor or beneficiary;
- any reforms should not result in tax administration interfering in the proper administration of a trust.

We welcome the opportunity to participate in the consultation process. We provide our general comments and submissions in Section 2 below. Our comments and submissions on the specific consultation questions raised follow in Section 3 of the report.

If you require any further information in relation to the submissions and comments included in this report please do not hesitate to contact Karen Payne on +61 2 9921 8719 or karen.payne@minterellison.com.

Glossary of Terms

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*
The Report	*Improving the taxation of trust income*

1. General Comments and Submissions

Executive Summary

We consider that:

1. The interim reforms should reflect the conduit nature of a trust and should permit income to pass through a trust to investors and beneficiaries of the trust by reference to their entitlements under the deed, including entitlements in income by class of income and any related tax attributes.
2. Any tax reforms should not result in tax administration interfering in the proper administration of a trust.
3. Option 3 may be adopted as an interim measure since (except for testamentary trusts) it will provide a safety net where there is no power under the trust deed to include capital gains as part of distributable income. We would expect that this will have minimal impact where capital gains are included in the distributable income of a trust – that is, where there is an income equalisation + re-characterisation clause.
4. Option 1 may be adopted as an interim measure where the trustee elects that it should apply and accordingly where it is not adverse to the interests of the beneficiaries of the trust. We also consider that it will be important to have sufficient opportunity to conduct a comprehensive review so that all items of notional taxable income and non deductible expenditure are excluded from the definition of distributable income. We also consider that the proportionate view should continue to apply under this option.
5. Option 2 should not be adopted as an interim measure.
6. The Government should confirm that no trust resettlement will arise where trust deeds are amended to conform with the interim reforms.
7. A definite timetable should be adopted to complete the review and taxation reforms for trusts so that these interim measures do not apply indefinitely.
8. The concept of a 'fixed trust' for the purposes of the Tax Act should be amended to allow franking credits to pass through a trust consistent with the streaming of such dividends and where the trust is not a 'family trust'.

2. Detailed Comments, Submissions and Observations

2.1 the reforms should reflect the conduit nature of a trust

If the proposed reforms confirm the manner in which both dividends and capital gains may flow through a trust this would be consistent with the conduit nature of a trust and the respective entitlements of beneficiaries under the terms of a trust. That is, a trust does not have legal identity but rather is a relationship between a trustee and beneficiaries in relation to trust property. We consider that this conduit treatment should be recognised and confirmed for other classes of income where there is any ambiguity arising from the interaction between Division 6 and specific taxing provisions. Further comments and submissions on the specific consultation questions raised are included in Section 3 below.

2.2 the reforms should not interfere with the proper administration of a trust

We understand that the *Government is not suggesting that there should be any changes to the trust law* – refer page 1 of the Report. We understand that these reforms will apply equally to all trusts – private, discretionary, unit and hybrid trusts, unitised public trusts, registered managed investment schemes, unregistered managed investment schemes, listed trusts and foreign trusts deriving Australian 'sourced' income. We consider that different issues may be more or less important to particular trusts and their beneficiaries given such a wide diversity of trust arrangements. We have not fully considered the potential impact on all these different kinds of trusts but, in examining the various options, we consider there may be instances where the reforms may interfere with the proper administration of the trust.

We consider that collective investment vehicles (widely held and not) should be excluded from applying these interim reforms on the basis that the consultation time provided is too short to allow retail and wholesale collective investment vehicles to consider and implement information systems upgrades or trust deed changes and/or prepare relevant investor notifications for such changes (where required).

Where the interim measures are available at the election of the trustee taxpayer, then this may minimise the potential impact on trust administration.

2.3 Option 3 may be adopted as an interim measure

We consider that most trust deeds will include an income equalisation clause or income re-characterisation clause and accordingly, the effect of Option 3 should be minimal. Where the trustee does not have power to include capital gains as part of distributable income, then this option is likely to provide an appropriate and equitable tax outcome (except where the trust does not permit a distribution of capital – eg some testamentary trusts or inter vivos trusts which have distinct and separate classes of beneficiaries entitled to income and capital). Alternatively, where the trustee can elect to apply this option, then the trustee will be able to first confirm that the interests of the beneficiaries of the trust will not be adversely affected after considering the specific terms and arrangements applying to the trust. The proportionate view should continue to apply under this option. We outline below our summary of the advantages and disadvantages for this option.

Pros	Cons
Avoids trustee being taxed at the highest marginal tax rate in a year of income where only capital gains and no other income is earned by the trustee.	May require trustees to amend present entitlements under trust deeds to include capital gains – this may raise issues associated with the resettlement of a trust (including stamp duty) or may be difficult where an existing deed does not include a power to amend for this reform. The distinction between the proportionate, quantum and hybrid views may still need to be resolved.
Provides a more equitable tax outcome for all the beneficiaries of the trust.	Existing trust deeds may not allow a distribution of capital. Requires a trustee to distinguish receipts or expenses as income or capital for tax purposes before year end to satisfy present entitlement requirements (which is not always practical). What happens if the trustee doesn't make a determination in relation to a particular receipt by the end of the income year – what would be the default position?

Pros	Cons
May allow streaming for classes of income in accordance with the trust deed and entitlements under same.	Does not address problems caused by other non-cash amounts recognised by the trust (e.g. unrealised gains), which may result in beneficiaries being taxed on amounts that they have not yet received. While this may ultimately be a timing issue, further issues may arise if the unrealised gain is not ultimately realised, or the realised gain is less than the unrealised gain - refer for example Clark v Inglis [2010] NSWCA 144.

2.4 Option 1 may be adopted as an interim measure at the election of the trustee

We consider that Option 1 may be introduced as an election for trustees provided there is sufficient opportunity to conduct a comprehensive review so as to exclude all items of notional taxable income and non deductible expenditure from the definition of distributable income and provided the proportionate view continues to apply. We outline below our summary of the advantages and disadvantages for this option.

Pros	Cons
Broadly consistent with current practice adopted by large funds using income equalisation clauses in their trust deeds – potential for minimal change required.	May not be appropriate for all types of trusts (e.g. foreign trusts deriving Australian sourced income, testamentary trusts).
Excluding notional amounts and non deductible expenditure from distributable income should reduce the risk of the trustee being taxed (ie where beneficiary is presently entitled to the income) but may require amendments to the trust deed definition of distributable income to align with the newly defined distributable income.	Does not resolve difficulties arising where an amended assessment is issued in a later period which results in increased taxable income. This may arise due to a self assessed error, a Part IVA determination or the Commissioner deeming market value treatment in respect of a transaction. This can result in the following:

Pros	Cons
	• no beneficiaries being presently entitled to the increased income – trustee gets taxed at top marginal rate; or • particular beneficiaries being taxed on increased amount where amendment relates to their share of distributable income. Where a trustee is taxed on an amendment to taxable income this may raise personal liability issues for the trustee where the tax arising on amendments to taxable income of the trust cannot be indemnified out of (insufficient) trust property. The distinction between the proportionate, quantum and hybrid views may still need to be resolved.
Minimises the opportunity to manipulate the definition of distributable income since this is 'hard wired' to equate to modified taxable income.	Need to have clearly defined list of notional amounts which are excluded from the definition of 'distributable income' (exhaustive or inclusive definition?). Non deductible expenses also need to be excluded from newly defined distributable income.
Does not require an assessment of whether a particular receipt is income based on accounting concepts.	
May minimise the potential impact of trustee administration where trust income currently includes capital gains.	May require significant administration and systems changes where it does not.
Potentially avoids the mismatch between what beneficiaries are taxed on and what they are entitled to (i.e. what they actually receive).	Requires trustees to amend present entitlements under trust deeds to align with new definition of distributable income – this may be difficult for existing deeds where there is no power to amend. If trusts are amended, potential for resettlement and stamp duty issues.

Pros	Cons
Avoids the problem where only capital gains and no accounting income is earned by the trust in the income year (i.e. reduces risk of trustee being taxed).	Existing trust deeds may not allow distribution of capital.
May allow streaming for classes of income in accordance with the trust deed	

We consider that it will be necessary to ensure under this option that all notional amounts of taxable income and non deductible expenditure are identified and excluded from newly defined distributable income – otherwise adverse tax consequences may arise due to the difficulties in establishing present entitlement to such income. Some further consideration is also needed in respect of capital which is amortised for tax purposes.

We consider that collective investment vehicles should be excluded from applying Option 1 on the basis that the consultation time provided is too short to allow retail and wholesale collective investment vehicles to consider and implement information systems upgrades or trust deed changes and/or prepare relevant investor notifications for such changes (where required).

Unless the trust deed defines the net income of the trust to be (newly defined) distributable income, then there is a risk that beneficiaries will not be presently entitled to some of these amounts with the consequence that tax at the top marginal tax rate will apply to the trustee in accordance with section 99A of the ITAA 1936 (without credit for the investors or beneficiaries). Accordingly, it will be advisable for a trustee wishing to fulfil their fiduciary duties to amend the trust deed (subject to any powers of amendment and subject to protecting the interests of the beneficiaries) to ensure that net income of the trust or distributable income is the same as the newly defined distributable income.

This would result in an identical outcome when applying either the proportionate or quantum views. However, where there is an amendment to taxable income then it will be important to understand whether a quantum or proportionate view applies. We note that an amendment may arise through self assessment or through an amendment by the Australian Taxation Office and it may relate to a category of income that only some of the investors/beneficiaries share. Where all amendments are to be assessed at the highest marginal tax rate because the quantum view prevails, then we consider this will result in unfair tax consequences and will be inconsistent with the conduit nature of a trust. Where the amendment arises several years after the relevant year of income then it may not be possible to track down the relevant beneficiary to advise of the amendment required in the tax return – raising issues of tax collection.

Where the trustee is assessed then the trustee will have personal liability for the tax, subject only to the right of indemnity and there being available trust assets. This may have adverse consequences for trustees and impact efficient trust administration.

We understand that the Government is not directly concerned at this stage with the merits of the proportionate, quantum or hybrid views in allocating the taxable income of the trust. We consider that these interim reforms should confirm that the proportionate view continues to apply. Page 8 of the Report states that:

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 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.

We consider this could impose an onerous compliance obligation in the context of widely held trusts where this creates a requirement to trace receipts, gains and income that make up the (newly defined) distributable income to the underlying beneficiaries.

In particular where investors are investing and redeeming from a fund then there should be no requirement to trace receipts, gains and income to the time during which the investor was a member of the fund since this would be impracticable and impossible to implement. Although we consider

- a trust is a conduit relationship and should be treated as such for taxation purposes;
- conduit treatment suggests that character flow through for income categories and tax attributes should apply for the investor;

the direct tracing requirement suggested in the statement above is not practical.

Accordingly, we submit that it should be clear from the express terms in the legislation that this does not introduce a specific tracing requirement for a trustee to trace receipts, gains and income based on the time of the receipt to specific investors.

We submit that it would be preferable to base the present entitlement test having regard to the entitlements under the deed to share in classes of income such as follows:

…the test of present entitlement would be applied by looking to see which beneficiaries are entitled ***to share in distributions of the categories or classes of income that make up the (newly defined) distributable income of the trust for a year***

2.5 Option 2 should not be adopted as an interim measure

We consider that this option will not achieve the policy objectives stated because:

(a) We consider that the discrepancy between 'accounting' concepts of income and taxable income has given rise to the complexities that (in part) these reforms are trying to resolve.

(b) A definition of distributable income based on accounting income will by definition not achieve the specified objective of better aligning a trust's distributable income with its taxable income.

(c) Trustees will be required to adopt accounting standards for the purposes of trust administration and changes in accounting standards will result in changes to distributable income for tax purposes.

(d) Accounting standards do not always result in a concept of 'income' to which there can be present entitlement and in some cases can result in counter intuitive and perverse outcomes - for example, where distributions to beneficiaries of fixed trusts are treated as expenses of the trust so that there is no amount of accounting income.

(e) The distributable income amount will be aligned with accounting standards, such that unrealised gains and losses put through the income statement could materially impact what is required to be distributed to ensure no assessment falls on the trustee.

We outline below our summary of the advantages and disadvantages for this option.

Pros	Cons
When combined with a power to re-characterise receipts as income, this type of definition could be flexible.	In some markets, an accounting-based definition may not be as familiar to trustees compared to a taxable income based definition.
Beneficial to trustees already applying GAAP.	Increased trust administration may arise where trustee does not already apply GAAP.

Pros	Cons
	This is particularly relevant for smaller trusts (e.g. family trusts).
	Accounting income may include certain amounts which are not recognised for tax purposes (e.g. unrealised gains). Where accounting and tax income are not identical, beneficiaries will be taxed on amounts which they are not entitled to receive. While this may ultimately be a timing issue, further issues may arise if the unrealised gain is not ultimately realised, or the realised gain is less than the unrealised gain. If unrealised gains to be excluded, may then need to define 'realised' or 'unrealised' gains.
	May require trustees to amend present entitlements under trust deeds to align with accounting income – this may be difficult for existing deeds where there is no power to amend. If trusts are amended, potential for resettlement and stamp duty issues.
Potentially avoids issues associated with amended assessments where a proportionate view applies.	Where there is no accounting income in the year (i.e. where expenses exceed receipts or where only capital gains arise), the trustee will be taxed on the net income (as no beneficiary presently entitled) and any excess franking credit offset will be lost (as is non-refundable).

2.6 the Government should confirm that no trust resettlement will arise where trust deeds are amended to align with the interim trust reforms

The current position regarding the circumstances in which a trust can be "resettled" for income tax purposes as a result of an amendment to the deed remains unclear because of a discrepancy between the Commissioner's stated position and recent case law. The Commissioner's published "Statement of Principles" on this subject has not been updated to reflect more recent decisions. There are divergent views about the views expressed in the Statement of Principles and in any case it is difficult to provide a 'clean' or unqualified opinion on whether amendments to trust deeds will constitute a resettlement given the views currently expressed by the Commissioner. This 'uncertain' state of affairs should be clarified. We consider that the Commissioner's Statement of Principles should be amended and an exemption from resettlement risk introduced through legislative amendment where trust deeds are amended to accommodate these interim reforms to Division 6, particularly where they are to be implemented in a short period of time.

The question of whether an amendment to a trust deed to give effect to the interim trust reforms will result in the imposition of Stamp Duty must also be considered.

2.7 a definite timetable should be announced to complete the review and taxation reforms for trusts

The alternatives set out in the Discussion Paper are intended to resolve as an interim measure various uncertainties arising from the operation of Division 6. Without a detailed analysis and consultation process, the problems which exist cannot be remedied in the short term for the broad range of trusts and each of the alternatives will still result in a degree of uncertainty for trustees and beneficiaries. Although we understand that interim reform to the system of taxing trusts and beneficiaries is urgent and in the interests of certainty, we consider these interim measures should apply on an interim basis only. Accordingly we submit that a timetable to complete the review of taxation of trusts, including managed investment trusts should result in a completed review within a short a time as possible and in any event no longer than 2 years. A preferable approach to resolve the perceived problems would be better facilitated by an early and detailed rewrite of Division 6 into the *Income Tax Assessment Act 1997* (Cth).

2.8 the concept of a 'fixed trust' for the purposes of the Tax Act should be amended to allow franking credits to pass through a trust consistent with the streaming of such dividends and where the trust is not a 'family trust'

The current rules broadly only allow franking credits to pass through a trust that is a fixed trust or a trust that has made a family trust election. Following the decision in *Colonial First State Investments Limited v Commissioner of Taxation* [2011] FCA 16, we consider there is significant uncertainty about the circumstances in which a trust can be a fixed trust for tax purposes, since this appears to depend upon the Commissioner exercising his discretion. Although we do not consider that the Parliament intended for a trust to fail the fixed trust test merely because the deed or the Corporations Act includes a power to amend the rights of members under the deed, the decision in *Colonial First State Investments Limited v Commissioner of Taxation* [2011] FCA 16 effectively results in a fixed trust arising only where the Commissioner has exercised his discretion under sub-section 272-5(3) of Schedule 2F to the *Income Tax Assessment Act 1936* (Cth) to treat trusts as fixed trusts. This is not an efficient or practical way to administer the tax laws. We consider that the government should amend the legislation to clarify which trusts will be treated as a fixed trusts for income tax purposes or failing that, the Commissioner should clearly announce that he will exercise his discretion under sub-section 272-5(3) of Schedule 2F to the *Income Tax Assessment Act 1936* (Cth) to treat trusts as fixed trusts.

2.9 Further Alternative - entitlements under the trust deed

A number of the authors of this submission provided comments and suggestions as part of the submission by the Taxation Committee of the Law Council of Australia, including in relation to the alternative option described in that submission. We would welcome the opportunity to develop this alternative further but acknowledge that it may not be implemented in the short time frame allowed for these interim measures. We consider this alternative produces the same result that would arise where capital gains are included as part of distributable income and where a proportionate view operates in relation to the class of entitlement under the deed.

The key advantages of this approach are:

(a) that it is consistent with the "conduit" nature of a trust; and

(b) there would be no requirement to redefine 'income' and 'capital' of the trust. That is, since any increase to which a beneficiary is entitled will be relevant for the purposes of allocating the taxable income of the trust.

Further details are included at Annexure A.

3. Specific Consultation Questions

Better aligning the concepts of distributable and taxable income

3.1 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)?

We consider that a gross capital gain should be included in calculating the taxable income of the trust and the discount claimed by the beneficiaries consistent with their 'present entitlement' to share in this capital gain. We consider this is consistent with the conduit nature of a trust. However some anomalies can arise where the capital gain amount is less than the distributable income of the trust. These anomalies are discussed further below.

3.2 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?

We consider that notional amounts excluded from the definition of distributable income should comprise any amounts not actually received by the trustee in cash or cash equivalents during the period (e.g. franking credits, deemed dividends etc). In this regard, we consider that no notional amounts should be included in the definition of distributable income since it will be impossible to satisfy the present entitlement requirement in relation to these amounts.

Similar considerations in relation to the impossibility of satisfying the present entitlement requirement also apply in relation to non deductible expenditure incurred by a trustee.

3.3 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?

We consider that adjustments should be made where timing differences exist between distributable income and the trustee's calculation of income pursuant to the trust deed. We consider this is a potential difficulty arising under Option 1 and which does not arise under Option 3.

This type of adjustment would also assist to address anomalies arising from unrealised gains. We consider that unrealised gains should not be included in the definition of distributable income unless they might also be included in taxable income eg TOFA fair value elections. This avoids the issue of beneficiaries being taxed on amounts which they have not yet received and may never receive (e.g. where the realised gain ends up being lower or reversed).

3.4 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?

We consider that a specific anti-avoidance measure is not required. As the Federal Court decision in *Forrest v Commissioner of Taxation [2010] AATA 325* illustrates, a power used inappropriately by a trustee to classify a receipt as a capital gain is not unlimited and will be read down by the Courts where appropriate. The re-classification of a receipt from income to capital that is made to obtain a tax benefit should be caught under the existing anti-avoidance provisions in Part IVA – that is, where the general power of the trustee to classify a receipt as income or capital for tax purposes is used to obtain a tax benefit. We consider that where Option 3, Option 1 or the alternative option outlined in Annexure A is adopted then such integrity measures will not be required since taxable income will be allocated by including an amount of a capital gain.

3.5 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?

Yes we consider that capital gains made by the trust should be included in distributable income so that in allocating taxable income, income beneficiaries are not taxed on capital gains that only benefit capital beneficiaries. This is consistent with the conduit nature of a trust.

Streaming of certain trust amounts

3.6 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?

We submit the purpose of a 'streaming' provision is to regard the trust as a conduit – that is, similar to the approach in *Charles,* ensure that income and gains of a Division 6 trust retain their character in the hands of a beneficiary that is entitled to such income and gains.

On this basis, we submit a beneficiary of a Division 6 trust should be taxed on dividends only where they are entitled to receive the dividends under the terms of the trust deed, and should be entitled to the franking credit in relation to those dividends, even where there is no 'net income' of the trust - that is, where the trust is in loss or has made a break even position. However, as the legislation is currently drafted, a beneficiary is not entitled to claim a refundable franking credit where there is no 'net income' of the trust included in the beneficiary's assessable income (for example, where there are deductible trust expenses or operating losses, which result in the 'net income' of the trust being a 'loss').

If a taxpayer has a direct ownership interest in shares that give rise to imputation credits but taxable income is Nil, a refund of the franking credits is still available. To achieve a 'conduit' tax treatment, we submit that similar treatment should be afforded beneficiaries that derive franked dividends through a trust. This could be achieved by 'extracting' the dividend component from the trust distribution of net income and provide a full offset for the beneficiaries.

For example, if a trustee received franked dividends of $700, incurred deductible expenses of $500, and the sole beneficiary was entitled to all of the "net income" of the trust, then the beneficiary:

- would have assessable income from the trust of $200;
- would treat $700 (the cash dividend) as having been derived as a dividend from share equity;
- would be entitled to an offsetting deduction of $700 (to prevent "double taxation");
- would be assessed on the imputation 'gross up" of $300'; and
- would be entitled to a potentially refundable imputation credit of $300.

This approach more closely matches the tax treatment that would have arisen where the beneficiary had derived the franked dividends directly, while retaining the correct overall 'net income' entitlement of the beneficiary in the particular year.

Other dividends

Similarly, we submit that Treasury should take this opportunity to align the tax treatment of all dividends (including unfranked dividends, assessable foreign source dividends with foreign tax offsets, and exempt foreign source dividends) with the proposed treatment of franked dividends as outlined above.

That is, we submit that all dividends derived by a trustee should "flow through" the trust to the entitled beneficiary as if derived by the beneficiary as a result of direct holdings of the equity interests, even where the 'net income' of the trust is not more than Nil (i.e., where the trust has a 'loss'). This could be achieved by 'extracting' the dividend component from the trust distribution of net income and (where necessary) provide a full offset for the entitled beneficiaries.

- For example, if a trustee received foreign source dividends of $850 (being $1000 reduced by 15% withholding tax at source), incurred deductible expenses of $500, and there was a sole beneficiary entitled to all of the "net income" of the trust, then the beneficiary would have assessable income from the trust of $350;
- would treat $1000 (the cash dividend, "grossed up" for the foreign tax withheld) as dividends derived by them from a foreign company;
- would be entitled to a foreign tax offset of $150; and
- would be entitled to a deduction of $850 (to prevent "double taxation").

If the "net income" of the trust included dividends that, if derived by a company that was not a trustee, would have been non-assessable non-exempt income under s23AJ, then that exemption should apply at the beneficiary level, where the entitled beneficiary is a company. For example, if the "net income" included

$200 that would have been exempt under s23AJ, and a company beneficiary was entitled to $100 of that dividend, then the company beneficiary that is entitled to this dividend:

- would have assessable income from the trust of $100;
- would be treated as having derived the $100 dividends from a direct equity interest in the foreign company (and would claim the s23AJ exemption); and
- would be entitled to an offsetting deduction of $100 (to exclude the exempt dividend their share of the assessable "net income" of the trust).

This approach more closely matches the tax treatment that would have arisen where the beneficiary had derived the dividends directly, while retaining the correct overall 'net income' entitlement of the beneficiary in the particular year.

3.7 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?

We consider that conduit treatment should equally apply for capital gains received through a trust.

To achieve 'conduit' tax treatment, we submit that similar treatment should be afforded beneficiaries that derive capital gains through a Division 6 trust. This would be achieved by extracting the capital gain component from the 'net income' of the trust included in the entitled beneficiary's assessable income, and provide an offsetting current deduction for the beneficiary in respect of the whole capital gain derived by the trust.

For example, if a trustee derived a gross capital gain of $800 (which would qualify as a 'discounted' capital gain), incurred deductible expenses of $500, and each beneficiary was equally entitled to all of the "net income" of the trust, then the entitled beneficiaries:

- would treat $800 (the un-discounted capital gains derived by the trustee) as having been made by them for the purposes of Step 1 of the method statement in s102-5; and
- would be entitled to an offsetting deduction of $800 (to prevent "double taxation").

This approach more closely matches the tax treatment that would have arisen where the beneficiary derived the capital gains directly, while retaining the correct overall 'net income' entitlement of the beneficiary in the particular year.

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

Under a 'conduit' approach, the taxable income calculation of beneficiary would include their "share" of:

- each item of assessable income derived by the trustee; and
- each allowable deduction incurred by the trustee in relation to that assessable income.

We support this model for taxing the assessable income of a Division 6 trust, and recommend that beneficiaries be assessed on the capital gains derived by the trustee according to the beneficiary's entitlement to those gains under the trust deed, rather than the extent to which these gains are reflected in the beneficiary's share of the 'net income' of the trust (which is commonly affected by other assessable income and allowable deductions of the trustee during the financial year).

Our recommended approach would assess the entitled beneficiary under Division 102 on the capital gain derived by the trustee. As a consequence, we support a full offset deduction under Subdivision 115-C determined by reference to the trust entitlements of the entitled beneficiary to capital gains, and not determined by reference to the "net income" assessed to the beneficiary under Division 6.

Annexure A – Alternative Option - Trust Entitlements

Under this alternative, the taxable income of the trust is attributed to the beneficiaries of the trust according to each beneficiary's entitlement (as determined under the trust deed) to share in realised increases in the trust fund (that is, both income and capital) during the financial year. Under this approach the proportionate view will apply to determine the beneficiary's share of taxable income - on the basis that the trust is to be treated as a conduit for taxation purposes.

The key advantages of this approach are:

- it is consistent with the conduit nature of a trust; and
- there would be no requirement to redefine 'income' and 'capital' of the trust. That is, since any increase to which a beneficiary is entitled will be relevant for the purposes of allocating the taxable income of the trust.

Further analysis about the specific application of this proposal to a broad range of scenarios would be required, but we provide the following discussion and examples to illustrate the intended operation of this alternative.

For example:

Trust A has trust property that consists of shares in listed companies.

Beneficiary B1 is entitled to all of the income under the terms of the deed.

Beneficiary B2 is entitled to all of the capital under the terms of the trust deed.

The net income in FY11 is $70,000 and the taxable income is $100,000 after including imputation credits.

The value of the property increased by $100,000 during the FY11, but this 'gain' remains unrealised, since the property has not been sold during FY11.

During FY12 the gain on the property is realised. A capital gain of $100,000 arises.

The net income in FY12 is also $70,000 and the taxable income is $200,000 (being $100,000 capital gain and $100,000 grossed up dividend income).

The taxable income would be allocated as follows:

	FY11 – Trust entitlements	FY11 – Allocation of Taxable income	FY12 – Trust entitlements	FY12 – Allocation of Taxable income
B1	70,000	100,000	70,000	100,000
B2			100,000	100,000
	70,000	**100,000**	**170,000**	**200,000**

The entitlements to income result in an allocation of that class of income to Beneficiary B1.

The entitlements to capital under the trust deed result in an allocation of the capital gain to beneficiary B2.

This is the same result that would arise where capital gains are included as part of distributable income. The proportionate view operates by class of entitlement so that the trust is treated as a conduit vehicle.

For example:

Trust A has trust property that consists of commercial property which is leased.

Beneficiary B1 is entitled to all of the net rental income under the terms of the deed.

Beneficiary B2 is entitled to all of the capital under the terms of the trust deed.

The net rental income in FY11 is $50,000 and the taxable income is $45,000 after claiming Division 43 allowances.

The value of the property increased by $100,000 during the FY11, but this 'gain' remains unrealised, since the property has not been sold during FY11.

During FY12 the gain on the property is realised. A capital gain of $120,000 arises due to the reduction in the cost base of the building arising from Division 43 allowances (ss.110-45(1B), (4) and (6)).

The net rental income in FY12 is also $50,000 and the taxable income is $165,000 (being $120,000 capital gain and $45,000 rent after claiming Division 43 allowances).

	FY11 – Trust entitlements	FY11 – Allocation of Taxable income	FY12 – Trust entitlements	FY12 – Allocation of Taxable income
	1	2	3	4
B1	50,000	45,000	50,000	45,000
B2			100,000	120,000
	50,000	**45,000**	**150,000**	**165,000**

The entitlements to rental income result in an allocation of that class of income to Beneficiary B1.

The entitlements to capital under the trust deed result in an allocation of the capital gain to beneficiary B2.

The Division 43 deductions may be more correctly allocated to the capital beneficiary. However, quarantining the deduction in this way may negate the statutory effect of the Division.

This is the same result that would arise where capital gains are included as part of distributable income – subject to any different treatment for Division 43 deductions. The proportionate view operates by class of entitlement so that the trust is treated as a conduit vehicle.

We outline below our summary of the advantages and disadvantages for this option.

Pros	Cons
Achieves an equitable 'conduit' allocation of taxable income based on entitlements to share in 'realised' increases in the trust fund during the financial year	The conduit treatment will not be fair unless a tracing exercise can be performed by the trustee and which is typically impracticable. Beneficiaries may be allocated a taxable income amount that is different in $amount from their entitlements under the trust deed.

Pros	Cons
Avoids the need to redefine net income of the trust to align with a (new definition) for tax purposes. Avoids the need to distinguish receipts or payments as income or capital – unless required for streamed entitlements. Avoids the need to amend present entitlements under the trust deed to align with a (new definition) of distributable income for tax purposes.	All distributions from the fund (excluding contributed equity) will need to be accounted for. New subscriptions to the trust fund will need to be accounted for and excluded from any calculation of the increase in trust property.
Minimises the opportunity to manipulate the definition of distributable income since all accretions to the trust fund (that are not unrealised) will be relied upon to allocate the taxable income of the trust across all beneficiaries.	Unrealised gains to be excluded since these may not ultimately be realised and would not generally result in an amount included in the taxable income of the trust.
Avoids the need to identify and monitor taxable income items that should be excluded from the definition of 'distributable income'	Creates a need to define 'realised' or 'unrealised' gains since unrealised increments in trust property (eg building appreciation) will not typically generate taxable income. Some (eg TOFA fair value elections and other mark to market exceptions) will need to be excluded from any definition of unrealised gains or included in realised gains.
Minimises the potential impact on trust administration.	
Allows streaming for classes of income in accordance with the trust deed	The distinction between the proportionate quantum and hybrid views may still need to be resolved.
Should not require tracing – that is, a realisation of gains and a tracing of proceeds to underlying beneficiaries – provided 'the trust' is regarded as a genuine 'flow through' or tax transparent entity.	May require specific taxing provisions to be identified and amended to make clear that a conduit treatment is achieved when read in conjunction with section 97 of Division 6.
Does not result in trustee being necessarily taxed on an amendment to taxable income and does not raise personally liability issues for the trustee	Beneficiaries will be taxed on the taxable income of the trust

Pros	Cons
where the tax arising on amendments to taxable income of the trust cannot be indemnified out of insufficient trust property	Any amendment to taxable income (eg self assessed or by ATO) will need to be allocated to beneficiaries or taxed to the trustee. The distinction between the proportionate quantum and hybrid views may still need to be resolved.
Beneficiaries will be taxed on the taxable income of the trust in accordance with a conduit approach	Tracing beneficiaries to advise of any amendment to taxable income may be difficult in non-family trust contexts where the amendment arises many years later. The distinction between the proportionate quantum and hybrid views may still need to be resolved

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