Modernising the taxation of trust income — options for reform

Consultation Paper
November 2011

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ISBN 978-0-642-74758-7

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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.

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Closing date for submissions: 10 February 2012

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CONTENTS

FOREWORD VII

1. INTRODUCTION 1
   - 1.1 Background 1
   - 1.2 Objective of the Review 2
   - 1.3 Scope of the Review 3
   - 1.4 Review process 3

2. TAXATION OF TRUSTS 4
   - 2.1 Historical development of trusts 4
   - 2.2 Current taxation of trust income (Division 6) 5

3. PROBLEMS WITH THE OPERATION OF DIVISION 6 9
   - 3.1 Scope of Division 6 9
   - 3.2 Meaning of key terms in Division 6 10
   - 3.3 Anomalous outcomes under the current approach 14
   - 3.4 Determining present entitlement by year end 15
   - 3.5 Character flow-through and streaming 16
   - 3.6 Amended assessments and 'nil' assessments 17
   - 3.7 Application of section 99B 17
   - 3.8 Application of section 97 to exempt and non-assessable non-exempt income 18

4. INTERACTIONS BETWEEN DIVISION 6 AND OTHER PARTS OF THE TAX LAW 19
   - 4.1 Division 6 and the capital gains tax provisions 19
   - 4.2 Division 6 and the franked distribution rules 19
   - 4.3 Division 6 and the consolidation provisions 20
   - 4.4 Division 6 and the withholding tax provisions 21
   - 4.5 Division 6 and the non-commercial loan provisions (Division 7A) 21
   - 4.6 Division 6 and the new managed investment trust regime 22
   - 4.7 Division 6 and the TFN withholding rules 22
   - 4.8 Division 6 and the trustee beneficiary reporting rules 23

5. OTHER ISSUES WITH THE OPERATION OF THE TRUST INCOME TAX PROVISIONS 24
   - 5.1 Fixed trusts 24
   - 5.2 Trust loss rules 25
   - 5.3 Family trust rules 26

6. POSSIBLE APPROACHES TO REFORMING DIVISION 6 27
   - 6.1 A minor tune-up or a major service? 27
   - 6.2 Can one size fit all? 27
   - 6.3 Simplifying the link between trust and tax law 28
   - 6.4 The key elements of any approach to taxing trust income 28
   - 6.5 Transitional issues 31

7. CHANGES TO IMPROVE THE OPERATION OF DIVISION 6 32
   - 7.1 Clarifying the scope of the trust income tax provisions 32

7.2 Extending the time for determining entitlements 33
7.3 Providing certainty about character flow-through and streaming 33
7.4 Definite amendment periods for trustees 34
7.5 Clarifying the treatment of expenses 34
7.6 Clarifying the scope of section 99B 34
7.7 Separate rules for taxable, exempt and non-assessable non-exempt income 35

8. OPTIONS FOR REFORMING THE TAXATION OF TRUST INCOME 36
8.1 Patch model 36
8.2 Proportionate within class model 37
8.3 Trustee assessment and deduction model 39

QUESTIONS FOR CONSULTATION 43

ABBREVIATIONS 45

APPENDIX A: EXAMPLES OF THE OPERATION OF THE PATCH MODEL, THE PROPORTIONATE WITHIN CLASS MODEL AND THE TRUSTEE ASSESSMENT AND DEDUCTION MODEL 46

APPENDIX B: SUMMARY OF KEY FEATURES OF OTHER TRUST REGIMES 53
United States of America 53
Canada 54
United Kingdom 55
New Zealand 57
Ireland 58
South Africa 59

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* (Division 6) and rewriting them into the *Income Tax Assessment Act 1997*.

The interaction of the trust and tax law has been an ongoing issue for some time.

I am therefore pleased to release this consultation paper, which explores the current issues impeding the effective operation of Division 6, as well as those impeding the effective taxation of trusts more broadly.

This consultation paper also highlights a number of options for reform which will ensure that businesses and individuals can continue to use trusts, with confidence that the tax outcomes applying to their circumstances are fair and consistent, whilst ensuring the community that the use of trusts does not provide inappropriate opportunities to manipulate tax outcomes. These options have been developed drawing on the expertise of the private sector, through the Tax Design Advisory Panel and the Board of Taxation.

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

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

1. INTRODUCTION

1.1 BACKGROUND

The need to review the trust income tax provisions, especially those in Division 6 of Part III of the *Income Tax Assessment Act 1936* (Division 6)[1], has been identified on a number of occasions.

Over 20 years ago Hill J observed in *Davis v Federal Commissioner of Taxation*[2] that 'it is quite clear that neither interpretation of section 97 (quantum or proportionate)[3] produces a desirable result as a matter of tax policy and the scheme of Division 6 calls out for legislative clarification, especially since the insertion into the Act of provisions taxing capital gains as assessable income'.

More recently, the need for reform has been highlighted in the High Court's decision in *Commissioner of Taxation v Bamford*[4] *(Bamford)* and by the Australia's Future Tax System Review, which recommended that the trust rules should be updated and rewritten to reduce the complexity and uncertainty around their application[5].

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

The Government also asked the Board of Taxation (Board) about whether there were any issues with the taxation of trust income that needed to be addressed for the 2010-11 income year.

On 4 March 2011, the Government released a discussion paper[6] that canvassed options to implement the recommendations made by the Board to:

- better align the concept of 'income of the trust estate' (distributable income) with 'net income of the trust estate' (taxable income); and

- enable the 'streaming' of capital gains and franked distributions.

Following public consultation, the Government announced that the challenge of better aligning the concepts of distributable and taxable income would be deferred to this broader review of the trust income tax provisions.

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1 All legislative references in this paper are to the *Income Tax Assessment Act 1936* unless otherwise specified.
2 *Davis v Federal Commissioner of Taxation* (1989) 86 ALR 195 at 230.
3 Discussed in further detail in section 2.2.
4 *Commissioner of Taxation v Bamford*; *Bamford v Commissioner of Taxation* [2010] HCA 10 at 17.
5 Australia's Future Tax System Review Panel, *Australia's Future Tax System final report*, Commonwealth of Australia, May 2010, Canberra, p.191 — Recommendation 36. Available at: <http://taxreview.treasury.gov.au/content/FinalReport.aspx?doc=html/Publications/Papers/Final_Report_Part_1/index.htm>.
6 Treasury discussion paper, March 2011 — *Improving the taxation of trust income*. Available at: < http://www.treasury.gov.au/contentitem.asp?NavId=037&ContentID=1981>.

Amendments to enable the 'streaming' of capital gains and franked distributions were enacted in *Tax Laws Amendment (2011 Measures No.5) Act 2011* (TLAA No.5 2011).

1.2 Objective of the Review

The Government is updating and rewriting the trust income tax provisions to increase certainty and reduce compliance costs for the many hundreds of thousands of taxpayers that use trusts.

This is not a 'crack down' on the use of trusts. The Government considers that, where used appropriately, trusts are a legitimate structure through which Australians should be able to conduct their personal and business affairs — not a form of tax avoidance.[7]

In announcing this reform, the Government clearly stated that any options for reform canvassed as part of this public consultation process would be developed within the broad policy framework currently applying to the taxation of trust income. That is, the taxable income of a trust will continue to be assessed primarily to beneficiaries, with trustees being assessed to the extent that amounts of taxable income are not otherwise assessable to beneficiaries.

The five principles outlined below elaborate on this policy framework and provide a useful framework for comparing the options for reform canvassed in Chapter 7 and 8 of this paper:

1. Tax liabilities in respect of the income and gains of a trust should 'follow the money' in that they should attach to the entities that receive the economic benefits from the trust.

2. The provisions governing the taxation of trust income should be conceptually robust, so as to minimise both anomalous results and opportunities to manipulate tax liabilities.

3. The provisions governing the taxation of trust income should provide certainty and minimise compliance costs and complexity.

4. It should be clear whether amounts obtained by trustees retain their character and source when they flow-through, or are assessed, to beneficiaries.

5. Trust losses should generally be trapped in trusts subject to limited special rules for their use.[8]

In addition to retaining the broad policy framework that currently applies to the taxation of trust income, the Government remains committed to its fiscal strategy. Therefore any changes made as part of this process will have to be broadly revenue neutral.

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7 Assistant Treasurer and Minister for Financial Services and Superannuation the Hon Bill Shorten, press release no. 48 of 7 April 2011 — *Double backflip by Shadow Treasurer.* Available at: <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2011/048.htm&pageID=003&min=brs&Year=&DocType=0>.

8 The Deputy Prime Minister the Hon Wayne Swan announced in press release No. 123 of 12 October 2011, *Business Tax Working Group — Membership and Terms of Reference,* the terms of reference and appointments to a Working Group that will look at how our tax system can best help businesses respond to the pressures of a changing economy. In the first stage, the Working Group will look at changes to the tax treatment of business losses to increase productivity and relieve the taxation on new investment. Available at: <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2011/123.htm&pageID=003&min=wms&Year=&DocType=0>.

1.3 Scope of the Review

Given the complex nature of the trust income tax provisions, the Government is aware that there are a number of issues that could be examined as part of this review.

However, in order to ensure that the most pressing issues are given priority, the Government has sought advice from the private sector, particularly through the Tax Design Advisory Panel (TDAP) process and the Board, as well as from the Australian Taxation Office (ATO).

After examining this advice the Government has determined that the key issues impeding the effective taxation of trusts that require immediate reform include:

- the interaction between the distributable income and taxable income of a trust;
- the method by which the taxable income of a trust is allocated to either the beneficiaries or trustee of the trust;
- whether the amounts received by a beneficiary retain their character and source (and when 'streaming' of those amounts is effective for tax purposes); and
- the scope of Division 6 and other taxing provisions applying to trusts.

The Government will give priority to updating and rewriting the tax law giving rise to these issues. Priority will also be given to other parts of the tax law that may need to be updated and rewritten to ensure that any changes are able to operate effectively.

The private sector and the ATO identified a number of other areas of the tax law that would benefit from being updated and rewritten, including the fixed trust, trust loss and family trust rules contained in Schedule 2F. The current issues with the legislative definition of 'fixed trust' will be examined through a separate process.

The Government welcomes comments on the appropriate scope of this review, taking into account the possible delays and resulting uncertainty that may occur in attempting to address all of the issues with the taxation of trusts in a single process.

1.4 Review process

This consultation paper is an initial step in a larger ongoing process to facilitate public discussion about how to improve the operation of the current trust income tax provisions.

The Government is committed to extensive consultation with the community on these reforms and will ensure that all stakeholders have an opportunity to express their views before any final decisions are made about how to update and rewrite the trust income tax provisions.

Treasury has released a consultation strategy along with this paper. This document broadly outlines the principles that Treasury will adopt in consulting with stakeholders and can be accessed on the Treasury website at www.treasury.gov.au.

2. Taxation of trusts

2.1 Historical development of trusts

The broad notion of a 'trust', whereby one party looks after property for the benefit of another, has been around for thousands of years.[9]

The origins of the modern trust however, can be traced back to the legal system that evolved in England following its conquest by William the Conqueror in 1066.

William the Conqueror introduced a feudal system of land control into England shortly after his conquest. Broadly, under this system the 'Crown' asserted its ownership over all of the land in England and required land owners to pay feudal dues in return for the continued enjoyment of their lands.

Over time the concept of a 'use', which eventually developed into the modern trust structure, was developed to circumvent the payment of these dues.

Under a 'use' the feoffor (settlor) would instruct the feoffees (trustee) to hold the land for his use and thereafter for the use of those nominated by the feoffor by deed or will (beneficiaries).

Trusts continued to evolve following the creation of the 'use' and only became relatively settled with the adoption of common trust law principles at the end of the 19th century.

For the majority of the time that trusts have been in use they have been essentially simple relationships between an individual trustee and a small number of beneficiaries, in respect of particular trust property and authorised investments such as land or shares.

However, particularly over the last 40 years, the types of activities that are being conducted through trusts have grown significantly. Trusts are now used in a variety of situations, including:

- testamentary trusts which come into existence after the administration of a deceased estate has been completed;
- inter vivos trading or investment trusts formed to hold business assets or income producing investments mainly for members and associates;
- collective investment trusts formed to hold specific investment assets for a large numbers of investors in fixed proportions;
- superannuation and pension trusts;
- charitable trusts; and
- trusts created by statute or by order of a court.

9 For example, the Romans had developed a number of trust-like instruments including the 'fideicommissum', which were used primarily to ensure the effective transfer of family property from one generation to the next.

The ATO reported that around 660,000 trusts lodged tax returns for the 2008-09 income year — an increase of almost 50 per cent from the 1999-00 income year. Over the same period, the number of companies lodging tax returns increased by 27 per cent.[10] Trusts are used across a broad range of industries, particularly in industries that are characterised by small and family businesses.

2.2 Current taxation of trust income (Division 6)

The current rules that generally govern the taxation of trust income are in Division 6.

Under Division 6, beneficiaries are assessed on a share of the trust's taxable income based on their present entitlement to a share of the trust's distributable income. The trustee is assessed on any residual taxable income.

As a collection mechanism, Division 6 also assesses trustees in respect of some beneficiaries, such as non-residents or those under a legal disability, with credits preventing double taxation (where required).

2.2.1 Taxable income (net income of the trust estate)

The taxable income of a trust is determined in accordance with section 95. Broadly, it is the total assessable income of the trust, including any net capital gain, less (with some exceptions) allowable deductions, worked out as if the trustee were a resident taxpayer.

2.2.2 Distributable income (income of the trust estate)

The High Court in *Bamford* considered the meaning of the phrase 'income of the trust estate'.

The High Court held that the reference to 'income of a trust estate' takes its meaning from trust law — that is, the distributable income of a trust is calculated with reference to general trust law principles, having regard to the provisions of the relevant trust's deed and appropriate accounting principles.[11] Broadly, it is the amount of the income of the trust to which a beneficiary can be made presently entitled.[12]

Most modern trust deeds contain a term that allows the trustee of the trust to determine its distributable income, subject to certain limitations.

2.2.3 Share of distributable income

The High Court also considered the meaning of the phrase 'that share' of distributable income in *Bamford*.

10 In the 1999-00 income year approximately 450,000 trusts and 596,000 companies lodged returns. In the 2008-09 income year approximately 660,000 trusts and 762,000 companies lodged returns. See ATO Tax Statistics 1999-00 and 2008-09. Available at: <http://www.ato.gov.au/corporate/pathway.aspx?sid=42&pc=001/001/049>.

11 *Commissioner of Taxation v Bamford*; *Bamford v Commissioner of Taxation* [2010] HCA 10 at 36.

12 *Cajkusic v Commissioner of Taxation* [2006] FCAFC 164.

The Court determined that for the purposes of section 97 the phrase 'that share' means 'proportion'. Once the share of the distributable income of the trust to which a beneficiary is presently entitled is determined, the beneficiary will be assessed on that same proportion of the trust's taxable income.

This is commonly referred to as the 'proportionate approach'.

Previously there had been two competing approaches to interpreting section 97: the 'proportionate approach' and the 'quantum approach'.

Under the 'quantum approach' the term 'share' was taken to mean 'amount' rather than 'proportion'.

The difference between the 'quantum approach' and the 'proportionate approach' is most clearly demonstrated where a trust's distributable income is less than its taxable income. In these cases, a question arises as to whether the excess amount of the trust's taxable income is assessable to the beneficiaries, or to the trustee of the trust.

Example — different outcomes under the 'proportionate' and 'quantum' approaches

A trust has distributable income of $80,000 in the 2010-11 income year and taxable income of $100,000.

The trustee resolves to distribute 40 per cent of the distributable income to John and 60 per cent to James.

Under the 'proportionate approach' John is assessed on $40,000 and James on $60,000.

Alternatively, under the 'quantum approach' John would be assessed on $32,000 and James would be assessed on $48,000 — the amount of distributable income each actually receives. The trustee of the trust would be liable to pay tax on the remaining $20,000 of taxable income.

2.2.4 Present entitlement

The term 'present entitlement' has a technical meaning in trust law. Broadly, a beneficiary will have a present entitlement to the distributable income of a trust where they have:

- an interest in the distributable income of the trust that is both vested in interest and in possession; and
- a present right to demand and receive payment of trust income, whether or not the precise entitlement can be ascertained before the end of the year of income and whether or not the trustee has funds available for immediate payment.[13]

In certain circumstances, the tax law provides for a beneficiary to be taken to be presently entitled to trust income where the beneficiary may not have otherwise been taken to be so entitled.[14]

13 *Harmer and ors v Federal Commissioner of Taxation* (1991) 173 CLR 264.
14 See for example section 95A.

For an income year, a beneficiary's present entitlement to the distributable income of a trust must be determined by the end of the trust's income year, usually 30 June.[15]

2.2.5 Exempt income

Exempt income is ordinary or statutory income that is not assessable income.[16] Generally an amount will be made exempt by a provision of the income tax acts or another Commonwealth law.

A trust's exempt income is calculated as if the trustee were a resident taxpayer.[17]

Where a trust has exempt income it may be used to reduce any current year or carry forward losses of the trust. To the extent that there is any remaining exempt income, a beneficiary that is entitled to a share of the income of the trust will generally include in their exempt income their 'individual interest' in this amount (see section 3.8).

2.2.6 Non-assessable non-exempt income

Non-assessable non-exempt income is ordinary or statutory income that is not assessable and not exempt income as a result of a provision in the income tax law or another Commonwealth law.[18]

A trust's non-assessable non-exempt income is calculated as if the trustee were a resident taxpayer.[19]

Unlike exempt income, where a trust has an amount of non-assessable non-exempt income, it does not have to be used to reduce any current year or carry forward losses of the trust.

However, like exempt income, to the extent that there is non-assessable non-exempt income in a trust, beneficiaries that are entitled to a share of the income of the trust will generally include in their non-assessable non-exempt income their 'individual interest' in this amount.

2.2.7 Tax preferred amounts

Broadly, a tax preferred amount is any income of the trust for trust law purposes that is not included in its assessable income in working out its taxable income or, amounts of corpus. The term tax preferred amount is defined for limited purposes in section 102UI.

Generally, Division 6 does not operate to include tax preferred amounts in the assessable income of the beneficiaries of a trust.[20] However, where an entitlement to a tax preferred amount is ordinary

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15 In *Trustees of the Estate Mortgage Fighting Fund v Federal Commissioner of Taxation* [2000] FCA 98, in discussing the High Court authority of *Harmer and ors v Federal Commissioner of Taxation* (1991) 173 CLR 264, Hill J noted that present entitlement to the income of a trust must arise, if at all, by the end of the income year at the latest.

16 Section 6-20 of the ITAA 1997. The key types of exempt income are listed in sections 11-10 and 11-15 of the ITAA 1997.

17 Section 95.

18 Section 6-23 of the ITAA 1997. The key types of non-assessable non-exempt income are listed in section 11-55 of the ITAA 1997.

19 Section 95.

20 Though section 99B may technically apply, we understand that this would be rare in practice.

income in the hands of the beneficiary of a trust, it may be brought to tax through the ordinary income provisions.[21]

In addition, if a trust makes a tax preferred distribution and the relevant trust is not a discretionary trust[22] the amount of the distribution may be brought to tax through a reduction in the cost base of the beneficiary's interest in the trust. Where the beneficiary's cost base has already been reduced to nil, any further tax preferred distributions will generally give rise to a capital gain for the beneficiary.

2.2.8 Character flow-through and 'streaming'

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. Where these amounts are able to be 'streamed' trustees can determine the specific types of income appointed to specific beneficiaries.

Before the High Court's decision in *Bamford*, the practice of treating trusts as flow-through vehicles, either generally or subject to the terms of the trust deed, was widespread.

However, following the High Court's confirmation of the 'proportionate approach', there is significant concern about whether it was still possible to stream amounts or whether a beneficiary is assessed on a proportionate share of a 'blended' amount of the trust's taxable income.

In order to provide certainty, the Government introduced interim amendments in TLAA No.5 2011 to ensure that, where permitted by a trust's deed, the capital gains and franked distributions of the trust can be 'streamed' to beneficiaries that are 'specifically entitled' to those amounts and in effect retain their character for tax purposes.

21 See for example ATO Interpretative Decision 2011/58 and Taxation Ruling IT 2512.
22 ATO Taxation Determination 2003/28.

3. PROBLEMS WITH THE OPERATION OF DIVISION 6

This chapter outlines the key issues with the current operation of Division 6. These issues have been identified with the assistance of the private sector and the ATO.

The Government is aware that the issues contained in this chapter do not form an exhaustive list of all of the issues with the operation of Division 6. [23]

The Government welcomes comments on these and any other issues that taxpayers consider impede the effective and simple operation of the taxation of trust income.

3.1 SCOPE OF DIVISION 6

Although Division 6 has been in place broadly in its current form for over 30 years, the exact scope of the Division remains uncertain. In *Bamford*[24] the High Court highlighted that the Division applies to more than simply settlements and testamentary trusts, however the Court did not provide more detailed guidance about the actual scope of the Division.

The lack of certainty surrounding the scope of the Division has led to ongoing questions about:

- which trusts are actually subject to the operation of Division 6; and
- the way in which Division 6 interacts with other provisions in the income tax law.

Trusts are often categorised in various ways, including express trusts, constructive trusts, resulting trusts, bare trusts, blind trusts, fixed trusts, implied trusts, discretionary trusts, hybrid trusts and unit trusts.[25] The rules in Division 6 generally apply to all categories of trusts and, because of the extended definition of trustee (in section 6), may also apply to arrangements that are not trust arrangements under trust law (for example, deceased estates).

The recent review into establishing a new MIT regime[26], as well as the existing CGT[27] rules and proposed GST[28] treatment for so-called 'bare trusts'[29], highlights that it may not be appropriate for all trusts to be subject to Division 6.

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23 To facilitate discussion about the current shortcomings with the operation of Division 6 it is not necessary for this paper to individually canvass every issue.

24 *Commissioner of Taxation v Bamford; Bamford v Commissioner of Taxation* [2010] HCA at 29.

25 Although, as the High Court observed in *CPT Custodian Pty Ltd v Commissioner of State Revenue; Commissioner of State Revenue v Karingal 2 Holdings Pty Ltd* [2005] 224 CLR 98, labels like this have no fixed or normative meaning.

26 Board of Taxation, *Review of the tax arrangements applying to Managed Investment Trusts*, Commonwealth of Australia, August 2009 — Recommendation 48: that Investor Directed Portfolio Services (IDPS) and similar bare trust type arrangements be excluded from taxation under Division 6.

27 Section 106-50 of the ITAA 1997 applies the CGT rules to an absolutely entitled beneficiary on the basis that the acts done by the trustee are done by that beneficiary.

28 Former Assistant Treasurer and Minister for Competition Policy and Consumer Affairs the Hon Chris Bowen, Media Release No. 42 of 12 May 2009 — *Government Response to Board of Taxation Review of GST Administration*. Available at: <http://assistant.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2009/042.htm&pageID=003&min=ceb&Year=&DocType=0>.

The recent decision in *Colonial First State Investments Ltd v Commissioner of Taxation*[30] *(Colonial)* also touched on this issue, albeit indirectly, with the Federal Court 'looking through' a custodian trust and in effect ignoring the operation of Division 6. Following this decision, there has been significant debate about whether so-called 'bare trust' arrangements should be disregarded (or 'looked through') for tax purposes.

The ATO does not consider that the decision in *Colonial* can be applied in such a general way. In its decision impact statement, issued on 30 June 2011, the ATO confirmed that it will only 'look through' a custodial trust to treat relevant custodial assets as being held directly by the beneficiary in situations where the facts are materially the same as those in *Colonial*.[31]

Without further judicial or legislative clarification, there will continue to be uncertainty about which trusts are subject to Division 6.

In addition to the issues surrounding which trusts are subject to the operation of Division 6, the broad application of the Division also raises the possibility of multiple provisions applying to tax the same amount of income.

3.2 Meaning of key terms in Division 6

Division 6 contains a number of key terms which lack supporting provisions, definitions and object clauses, including:

- 'trust estate';
- 'income of the trust estate';
- 'share' and 'individual interest'; and
- 'resident trust estate'.

The lack of common understanding about the meaning of these terms — as shown by continued litigation decades after their introduction — has contributed to a rise in complexity and compliance costs for users of trusts.

3.2.1 Identifying the 'trust estate'

The first step in determining whether or not Division 6 may apply to a trust is to determine what constitutes the relevant trust estate. Without first identifying what constitutes the 'trust estate', it is not possible to identify what constitutes the 'income of the trust estate' or 'net income of the trust estate'.

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29 A bare trustee is one who merely holds property on trust with no interest in, or duty as to, the trust property, except to convey it when required according to the directions of the beneficial holder (Osborn's Concise Law Dictionary, 7th edition).

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

31 ATO Decision Impact Statement - *Colonial First State Investments Ltd v Commissioner of Taxation*, released 30 June 2011. Available at: <http://law.ato.gov.au/atolaw/view.htm?Docid=LIT/ICD/NSD1190of2009/00001>.

The distinction between the 'income of a trust estate' and the 'trust estate' itself was canvassed extensively in *FCT v Everett*[32] (*Everett*). The Court referred back to the distinction made by Kitto J in the decision in *Stewart Dawson Holdings Pty Ltd v FCT*[33], commenting that:

> *Kitto J was making the point that when a person establishes a trust of his future income simpliciter, the income from which it is derived is the subject matter or corpus of the trust, not the fruit of it. To use the terminology of s95, it is because the income is the 'trust estate' that it cannot be 'the net income of' that trust estate.*

However, even with this judicial guidance there continues to be difficulties in applying the distinction between the 'income of the trust estate' and the 'trust estate' itself.[34]

3.2.2 'Income of the trust estate'

As noted in section 2.2 above, the High Court clarified in *Bamford* that 'income of the trust estate' takes its meaning from trust law. That is, the distributable income of a trust is calculated by reference to general trust law principles having regard to the provisions of the relevant trust's deed and appropriate accounting principles. This means that what constitutes 'income of a trust estate' can be as varied as trust deeds themselves.

Moreover, the Court did not resolve all of the uncertainty surrounding this phrase. For example, the Court did not have cause to resolve how notional amounts and expenses are to be treated or whether trustees have the power to treat income receipts of a trust as capital receipts.

In most cases it will be clear whether an amount represents 'income of the trust estate'. However, complications may occur where:

- trustees' accounts are deficient;
- it is unclear whether or to what extent trustees' discretions have been exercised;
- trustees have not had proper regard to the terms of the trust when determining or appointing income;
- the meaning of resolutions made by trustees are open to various interpretations; or
- the deed itself is ambiguous, difficult to interpret or even internally contradictory.

Notional amounts

When a trust deed attempts to equate the 'income of the trust estate' with the trust's taxable income (that is, net income as defined in section 95), an issue arises as to how notional amounts are treated. Notional amounts such as franking credits arguably do not form part of a trust's distributable income. This is because they do not represent accretions to the trust estate in the

32 *FCT v Everett* (1980) 143 CLR 440.
33 *Stewart Dawson Holdings Pty Ltd v FCT* (1965) 14 ATD 91.
34 See for example *Leighton v FCT* [2011] FCAFC 96.

relevant income year that are available for distribution, and to which a beneficiary may become presently entitled.[35]

In *Colonial* [36], Stone J recently endorsed the view that notional amounts (such as franking credits) are not capable of founding a present 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 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".*[37]

While it appears clear that these notional amounts cannot form part of the distributable income of a trust estate where there is no corresponding accretion to the estate, there remains some uncertainty about the treatment of other amounts such as gross-ups for foreign tax paid on behalf of a trustee, deemed dividends arising under Division 7A of Part III (Division 7A) or section 45B and deductions that are notional for tax purposes, such as deductions for the purposes of Division 41 or 43 of the ITAA 1997.

Determining distributable income may also be difficult where there are other actual accretions to the trust estate that are not treated under the trust's deed as 'income of the trust estate'.

Treatment of expenses

The term 'income of the trust estate' is a net, rather than gross, concept — it refers to the gross income of a trust reduced by any allowable expenses.

The way in which the trustee of a trust allocates expenses can be important as it can significantly alter the tax outcomes for individual beneficiaries or particular classes of beneficiaries in cases where the beneficiaries of the trust are entitled to different classes of income. This issue does not arise in cases where the beneficiaries of a trust are all entitled to the same class of income.

Although former section 50 did not expressly deal with the allocation of expenses[38], it provided some trustees with guidance in determining how to allocate expenses. However, since its repeal in 2006, the allocation of expenses has largely been determined in accordance with the general rules as set out in *Ronpibon Tin v FCT*[39] — that is, expenses should be apportioned on a 'fair and reasonable assessment of the extent of the relation of the outlay to assessable income'[40] subject to the application of the relevant trust deed.

Following *Bamford,* it might be expected that how expenses are allocated against income so as to determine the distributable income of the trust ought to be determined by reference to general trust principles, having regard to the trust deed and relevant accounting principles.

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35 Compare however *Thomas Nominees Pty Ltd v Thomas* [2010] QSC 417; 2010 ATC 20-223.
36 *Colonial First State Investments Limited v Commissioner of Taxation* [2011] FCA 16.
37 *Colonial First State Investments Limited v Commissioner of Taxation* [2011] FCA 16 at 88 (endorsed at 89).
38 Broadly, section 50 provided ordering rules for applying deductions against particular classes of assessable income.
39 *Ronpibon Tin N.L. v FCT* (1949) 78 CLR 47.
40 *Ronpibon Tin N.L. v FCT* (1949) 78 CLR 47 at 60.

Treatment of income receipts as capital receipts

The High Court's decision in *Bamford* supports the ability of a trustee to include capital receipts as 'income of the trust estate' where the trustee has the power to do so under the trust's deed.[41] However, it remains uncertain as to whether trustees also have the power to treat income receipts as capital receipts — and therefore not 'income of the trust estate'.[42]

The lack of clarity about the effect of trust re-characterisations creates uncertainty for taxpayers and increases compliance and administrative costs.

3.2.3 The use of 'share' and 'individual interest'

The inconsistent use of the terms 'share' and 'individual interest' throughout Division 6 has caused uncertainty in determining the amount of taxable, exempt and non-assessable non-exempt income that a beneficiary should include in their income.[43]

As discussed in section 2.2, the meaning of the term 'share' was recently determined in *Bamford* to mean 'proportion'.

The term 'individual interest' has been subject to considerably less judicial consideration. In *Everett*, Deane J stated that the meaning of the term 'individual interest' is the same as the term used in section 92 when determining the income or losses of a partner in a partnership.[44]

3.2.4 Resident trust estate

A trust estate will be a resident trust estate for an entire year of income if a trustee is an Australian resident at any time during that year or the central management and control of the trust estate is in Australia at any time during the year of income.[45]

This test may pose problems for trusts that have multiple trustees — only one of which may be in Australia during an income year.

A potentially more significant problem relates to determining the residency of a trust estate under relevant double taxation agreements and thus whether the trust is able to claim treaty benefits. As many tax treaties do not explicitly recognise trusts, and do not contain residency rules for trusts, the

41 In *Forrest v Commissioner of Taxation* [2010] FCAFC 6, the Court determined that a re-classification power was not an unlimited power to be exercised in the trustee's unconfined discretion. In the opinion of the Court, the power in that case was no more than an administrative power to be exercised in cases of uncertainty and could not be exercised by the trustee wrongly to classify a receipt as capital, when the receipt was, in truth, income.

42 See the ATO's decision impact statement in respect of *Commissioner of Taxation v Bamford*; *Bamford v Commissioner of Taxation* [2010] HCA 10. Available at: <http://law.ato.gov.au/atolaw/view.htm?docid=LIT/ICD/S310/2009/00001>.

43 Paragraph 97(1)(a) requires a beneficiary to include in their assessable income so much of 'that share' of the net income of the trust estate as is attributable to a period when they were an Australian resident or is attributable to an Australian source. However, paragraphs 97(1)(b) and (c) require beneficiaries (that are entitled to a 'share' of the income of the trust) to include in their exempt or non-assessable non-exempt income the amount of their individual interest in the trust's exempt and non-assessable non-exempt income. The use of these two apparently different concepts also occurs in sections 98 and 100.

44 *FCT v Everett* 78 ATC 4595 at 4611.

45 Subsection 95(2).

ability to apply residency tie-breaker rules[46] is often difficult and requires consideration of how the treaty applies to the trustees of the trust.

3.3 Anomalous outcomes under the current approach

Many of the problems that arise from the 'proportionate approach' in Division 6 stem from the fact that the distributable 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 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. The following example highlights how differences in a trust's distributable and taxable income can lead to unfair and anomalous outcomes.

Example — Income beneficiary assessed on amounts received by capital beneficiary

In the 2010–11 income year, the Daley trust generated $300,000 of rental income. The trust had no expenses. The trust's taxable income was therefore $300,000.

The trust deed has a re-classification clause that allows the trustee to treat receipts as income or capital of the trust at its discretion. The trustee exercises its power to re-classify $210,000 of the rent receipts as capital. The trust's distributable income was therefore $90,000.

(As noted in section 3.2.2, it is unclear whether the re-classification of income into capital would be effective for tax purposes — however, for illustration purposes this example assumes that it is.)

The trustee exercises its discretion to appoint income and capital to beneficiaries within the class of discretionary objects. All of the distributable income is distributed to a company, Gears Pty Ltd, and an amount of capital representing $210,000 of the rent is distributed to Adam.

As Gears Pty Ltd was presently entitled to all of the trust's distributable income, it is assessed on all of the trust's taxable income of $300,000. As a company, Gears is taxed at 30 per cent and has a tax liability of $90,000 — which it pays using the $90,000 received from the Daley trust.

Adam would not be assessed on the $210,000 rental receipt that was distributed to him as capital, despite receiving 70 per cent of the economic benefits of the trust for that year.

Many trusts have sought to use specific provisions in their deeds to avoid the problems that arise as a result of differences between distributable and taxable income. These provisions generally take the form of an 'income equalisation clause' or a 'reclassification clause'.

- An 'income equalisation clause' purports to equate the trust's distributable income with its taxable income. The clause might operate by default if the trustee fails to determine a different methodology for calculating the trust's distributable income.

46 Double Tax Agreements contain 'tie-breaker' rules to ensure that a dual resident 'person' (whether an individual, company or other entity) is treated as a resident of only one of the countries for the purposes of the agreement. See ATO Tax Ruling 2001/13 — *Income tax: Interpreting Australia's Double Tax Agreements*.

- A 're-classification clause', as the term suggests, gives 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 must be clearly expressed in the trust deed.

Whilst these approaches appear to effectively deal with the differences between distributable and taxable income, they both contain significant shortcomings. For example, income equalisation clauses may not be able to deal with notional amounts (see discussion at 3.2.2 above). Re-classification clauses may be able to be used to manipulate the tax liabilities of trust beneficiaries, inconsistent with the 'follow the money' principle.

Even with these improvised solutions, there remains uncertainty surrounding how to overcome the difficulties that arise where the distributable income of a trust does not equal its taxable income.

3.4 Determining present entitlement by year end

If there is part of the distributable income of a trust to which no beneficiary is presently entitled, the trustee is taxed — typically at the top marginal rate (plus the Medicare levy) — on that share of the trust's taxable income. If the trustee is assessed on any capital gains of the trust, the trustee will also lose the benefit of any CGT concessions (if applicable).

In order to avoid this treatment, the trustee must resolve to make beneficiaries presently entitled to the trust's distributable income, typically by 30 June.

As trustees may not be in a position to determine the exact distributable income of the trust at 30 June, as trust accounts are usually finalised well after 30 June, trustees will often resolve to distribute a proportionate share of income at 30 June to relevant beneficiaries rather than a dollar amount. In addition, many deeds stipulate that any income not applied by the trustee by 30 June each year is to be held for the benefit of named default beneficiaries. This has the effect of ensuring that one or more beneficiaries are presently entitled to the entirety of the distributable income of the trust by year end.[47]

To mitigate the issues with the end of year deadline for determining present entitlement, the ATO issued Income Tax Ruling IT 328 (IT 328) on 20 May 1966, which provided trustees until 31 August to exercise their discretion to pay or apply the income of the trust to beneficiaries.

Although this ruling provided an administrative solution, the recent decision in *Colonial* confirmed that this approach was not supported by the operation of the current tax law. Moreover, any such practice would not enable trustees to ignore entitlements already created at trust law — for example, as a result of default beneficiary clauses (which were not in wide usage when the ATO's administrative solution was developed).

The ATO has therefore withdrawn this ruling with effect from the 2011-12 income year.

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47 However, such a clause also means that any income distributions purportedly made by the trustee after year end have no effect.

The withdrawal of IT 328 has served to emphasise the inflexibility of the legislative requirement that entitlements must arise by the end of the relevant income year, as well as the administrative impracticality that this may present for trustees.

3.5 Character flow-through and streaming

The terms ‘character flow-through’ and ‘streaming’ are often used interchangeably. However, in this paper the terms are used to refer to two different (but related) concepts.

3.5.1 Character flow-through

Character flow-through refers to the idea that the character of amounts in the hands of a trustee is retained when those amounts are distributed to the beneficiaries of a trust.

There is a common perception that this is how trusts ordinarily work — the ‘conduit’ theory.

However, under the current income tax law, character retention is arguably only effective if there are specific provisions in the tax law that attribute specific tax characteristics to certain amounts, such as exempt income, non-assessable non-exempt income, capital gains and franked distributions.

The conclusion that the law works in this way finds support in the approach of the High Court in *CPT Custodian* and in particular its treatment of the earlier decision of the High Court in *Charles v FCT*.[48] However, even with this authority, the availability of character retention remains a live issue that is the subject of ongoing judicial interpretation.[49]

3.5.2 Streaming

The term ‘streaming’ refers to the ability of a trustee to direct different types of income to different beneficiaries of a trust.

There remains confusion about whether ‘streaming’ of particular types of income, profits or gains to particular beneficiaries is effective for tax purposes.

Following the High Court’s confirmation of the ‘proportionate approach’ in *Bamford*, taxpayers and their representatives expressed significant concern about whether it was still possible to stream amounts or whether a beneficiary is assessed on a proportionate share of a ‘blended’ amount of the trust’s taxable income.

After receiving advice from the Board, the Government introduced specific provisions in TLAA No.5 2011 to ensure that, where permitted by the trust’s deed, capital gains and franked distributions could be effectively ‘streamed’ for tax purposes.

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48 The decision in *Charles v Federal Commissioner of Taxation* (1954) 90 CLR 598 (*Charles*) is generally cited as authority for the existence of the conduit or flow-though principle. However, the High Court decision of *CPT Custodian Pty Ltd v Commissioner of State Revenue; Commissioner of State Revenue v Karingal 2 Holdings Pty Ltd* [2005] 224 CLR 98 confirms that *Charles* may not have the broad authority that has been suggested.

49 See, for example, *Greenhatch v FCT* [2011] AATA 479.

3.6 Amended assessments and ‘nil’ assessments

Under the current law there is no legislative prohibition on when an assessment can be issued to a trustee where they have not previously been assessed on an amount of income in the relevant income year. The potential for assessments to be issued well after the year in which beneficiaries have received a trust distribution can create considerable uncertainty for these trusts.

In order to address this the ATO has adopted an administrative practice so that any original assessment for a trustee is only issued within four years from the later of the due date for lodgement of the return or the actual lodgement date of the return — except where there has been fraud or evasion.

However, a number of taxpayers and their advisors are still concerned by the lack of any legislative protection against the issuing of assessments a number of years after the trustee considers the trust’s tax affairs to be finalised.

Accordingly, some trustees still ‘retain’ a nominal amount of distributable income to obtain a trustee assessment. This assessment ensures that the period for amending the trust’s return is limited to the normal review periods for amended assessments. This perceived need to retain a nominal amount in the trust creates unnecessary compliance and administrative costs for trustees and the ATO.

More generally, a number of administrative problems can arise because of misalignments between the lodgement times and the assessment and amendment periods for trustees and beneficiaries.

3.7 Application of section 99B

The High Court held in *Union Fidelity Trustee Co. of Australia Ltd v FCT*[50] (*Union Fidelity*) that, in calculating the taxable income of a trust for the purposes of Division 6, only Australian sourced income could be taken into account.[51] A significant effect of the decision was that (in the absence of an accruals regime) foreign source income could be accumulated by Australian residents in a trust without liability for Australian tax unless and until the trust income was distributed to a resident beneficiary.

A number of provisions were introduced into Division 6 to overcome the effects of this decision, such as sections 99B and 99C.

Broadly, section 99B applies to include certain trust distributions (income amounts paid to or applied for their benefit during an income year) in the assessable income of a beneficiary who was a resident at any time during the year to the extent that the amount has not previously been subject to tax.

Although the explanatory memorandum[52] that accompanied the introduction of section 99B highlights that the provision will normally apply where accumulated foreign source income of a non-resident trust estate (or of a resident trust estate that previously was not able to be taxed in

50 *Union Fidelity Trustee Co. of Australia Ltd v FC of T* (1969) 119 CLR 177.

51 As a result of the decision in *Union Fidelity Trustee Co. of Australia Ltd v FC of T* (1969) 119 CLR 177 amendments were made to the definition of the ‘net income of a trust estate’ to specify that the total assessable income of the trust estate is to be calculated as if the trustee were a resident taxpayer. The effect of this change is that income, whether from sources in or out of Australia, is included in the calculation of the ‘net income of the trust estate’.

52 Explanatory Memorandum to the *Income Tax Assessment Amendment Act 1979.*

Australia in light of the decision in *Union Fidelity*) is distributed to a resident beneficiary, there remains uncertainty as to the scope of the provision. One of the most significant concerns is about the extent to which it can apply to distributions from resident trusts.

There has been little judicial interpretation of section 99B. One of the few cases to examine the provision was *Traknew Holdings Pty Ltd v FCT*.[53] In this case, Hill J outlined that the introduction of the provision was intended to apply to distributions of accumulated income from non-resident trusts. However, Hill J did not determine the breadth of the provision, stating that 'it is not necessary to decide for the purposes of the present case whether the extreme width of section 99B and associated provisions require it to be read down having regard to the obvious legislative purpose in enacting it'.

Given the current expansive wording of section 99B, some uncertainty still exists about whether the section can apply on a broader basis than outlined in the explanatory memorandum accompanying *Income Tax Assessment Amendment Act 1979*.

3.8 Application of section 97 to exempt and non-assessable non-exempt income

Currently, the 'allocation' of taxable income, exempt income and non-assessable non-exempt income to beneficiaries of a trust is all determined under a single section (section 97). Furthermore, there are introductory words in the section that apply to all three types of income and refer to the trust's distributable income.

The common introductory words or 'chapeau' in this section arguably lead to two issues — depending on whether the exempt income or non-assessable non-exempt income forms part of the trust's distributable income.

Where amounts treated as exempt income or non-assessable non-exempt income form part of the trust's distributable income, a beneficiary that is presently entitled to such amounts will have a 'share of the income of the trust estate'.

Under the 'proportionate approach', there is a view that such beneficiaries may be assessed on a share of the trust's taxable income — even though they are only entitled to amounts that were treated as exempt or non-assessable non-exempt income.

Where the amounts do not form part of the trust's distributable income, the rules may not work appropriately for beneficiaries that only receive those amounts and no other distributable income.

There is a view that section 97 would not apply to include in such a beneficiary's exempt income or non-assessable non-exempt income their individual interest in such income because the beneficiary does not have a share of the trust's distributable income (as required in the introductory words). This would create an anomalous outcome, particularly when compared with the outcome for a beneficiary that was presently entitled to such income and also presently entitled to at least $1 of distributable income (and therefore is 'allocated' all of their individual interest in the exempt income and non-assessable non-exempt income of the trust).

53 *Traknew Holdings Pty Ltd v FCT* (1991) 21 ATR 1478.

4. Interactions between Division 6 and other parts of the tax law

The Government is aware that Division 6 interacts with a number of other areas of the tax law.

This chapter outlines some of the key areas of the tax law, outside of Division 6, that may need to be updated or rewritten to ensure that they interact appropriately with an updated and rewritten Division 6.

4.1 Division 6 and the capital gains tax provisions

Division 6 and the capital gains tax (CGT) provisions (particularly Part 3-1 of the ITAA 1997) interact in a number of ways. The most common of these occur:

- in determining how to tax a beneficiary's share of a trust's taxable income that includes a capital gain;
- when a beneficiary sells their interest in a trust; and
- where the beneficiary of a trust, such as a unit trust receives a tax preferred or capital distribution requiring a cost base adjustment.

The CGT provisions contain rules for dealing with taxable income that relates to the capital gains of a trust (Subdivision 115-C of the ITAA 1997). Broadly, these rules treat beneficiaries as having 'extra' capital gains (in addition to any they realised directly) based on their entitlement to the taxable capital gains of a trust. Where relevant, these rules also increase the assessable amount for a trustee (including where the trustee is assessed on behalf of a beneficiary under section 98).

The 'streaming' changes introduced in TLAA No.5 2011 broadly ensure that a beneficiary that is 'specifically entitled' to an amount representing a capital gain of a trust will be assessed on that gain. This can apply for a 'capital beneficiary' even though they are not presently entitled to any distributable income of the trust.

4.2 Division 6 and the franked distribution rules

Broadly, the franked distribution rules ensure that an entity that receives a franked distribution is assessed on the attached franking credit and is entitled to a matching tax offset. There are specific rules where the franked distribution is received through trusts or chains of trusts (Subdivision 207-B of the ITAA 1997).

The 'streaming' changes introduced in TLAA No.5 2011 broadly ensure that a beneficiary that is 'specifically entitled' to an amount representing a franked distribution will be assessed on that amount and receive the attached franking credits (subject to other eligibility rules).

4.3 Division 6 and the consolidation provisions

The consolidation provisions were introduced in 2002 to allow wholly owned groups of companies, eligible trusts and partnerships to form consolidated groups that are then treated as a single entity for tax purposes (Part 3-90 of the ITAA 1997). Broadly, this means that the subsidiary entities lose their individual income tax identities and are treated as parts of the head company of the consolidated group for the purposes of determining its income tax liability during the period in which they are members of the group.

The Government asked the Board to undertake a post implementation review of certain aspects of the consolidation regime in June 2009.[54]

On 9 December 2009, the Board released an initial discussion paper as the basis for further discussions. Chapter 4 of this paper considers the interactions between Division 6 and the consolidations regime as well as the key issues with their interaction.[55] This paper highlights that the main interactions between Division 6 and the consolidation regime occur in:

- determining how much of a trust's taxable income is assessed to each beneficiary and/or trustee when the trust is a member of a consolidated group for only part of an income year; and
- calculating the allocable cost amount of a trust that joins a consolidated group part way through an income year.

Following the completion of public consultation on its initial discussion paper, the Board released a position paper on 13 October 2010. This paper contains three position statements in relation to the taxation of trusts that join or leave a consolidated group during an income year.[56] These are that:

- A trust's taxable income, for the period inside and outside of a group, should be calculated broadly based on the income and expenses that are reasonably attributable to that period and a reasonable proportion of amounts that are not attributable to any particular period in the income year.
- A beneficiary's and the trustee's share of the trust's taxable income should be determined by taking into account events that happen after a trust joins or leaves a consolidated group.
- A consolidated group's tax liability in relation to the taxable income of a trust's non-membership period should be included in the allocable cost amount calculation.

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54 Former Assistant Treasurer and Minister for Competition Policy and Consumer Affairs the Hon Chris Bowen, media release No.58 of 3 June 2009. Available at: <http://treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2009/058.htm&pageID=003&min=ceb&Year=&DocType=0>.

55 Board of Taxation, Discussion paper — *Post Implementation Review into certain aspects of the consolidation regime*, Commonwealth of Australia, December 2009, Canberra. Available at: <http://www.taxboard.gov.au/content/content.aspx?doc=reviews_and_consultations/aspects_of_the_consolidation_regime/default.htm&pageid=007>.

56 Board of Taxation, Position paper — *Post Implementation Review into certain aspects of the consolidation regime*, Commonwealth of Australia, October 2010, Canberra. Position statements 4.1, 4.2 and 4.3. Available at: <http://www.taxboard.gov.au/content/content.aspx?doc=reviews_and_consultations/aspects_of_the_consolidation_regime/default.htm&pageid=007>.

The Government welcomes comments on whether interactions with the consolidation provisions should be considered as part of this process, or through a separate process.

4.4 Division 6 and the withholding tax provisions

The income tax law includes a withholding regime for dividends, interest and royalties paid to non-resident beneficiaries (Division 11A of Part III).

Under these rules, a beneficiary of a trust[57] that is presently entitled to a dividend, interest or royalty included in the distributable income of the trust is deemed to have derived the dividend, interest or royalty for the purposes of the withholding tax provisions. The trustee of the trust is then obliged to deduct withholding tax from any of these amounts before they are paid to the beneficiary. This obligation exists where the trust has distributable income even if the trust has no taxable income.[58]

Where withholding tax has been applied to a dividend, interest or royalty, these amounts are then treated as non-assessable non-exempt income. This treatment is intended to ensure that taxpayers are not also assessed under other provisions (including Division 6) on amounts which have been subject to, or specifically exempted from, withholding tax.

Similar withholding provisions are located in Division 840 of the ITAA 1997 and relate to the taxation of managed investment trusts.

4.5 Division 6 and the non-commercial loan provisions (Division 7A)

Division 7A is an integrity measure designed to ensure that the profits of companies are not paid to shareholders without being subject to the appropriate tax amount. It ensures that amounts paid, lent or forgiven by a private company to a shareholder (or a shareholder's associate) are treated as deemed dividends, unless they come within specified exclusions.

The Division can also operate to treat a payment, loan or forgiveness of debt to a shareholder of a private company (or an associate) as a deemed dividend where a private company has an unpaid present entitlement to income of a trust and the trustee of the trust makes a payment or loan to, or forgives a debt of, the shareholder of the private company (or their associate) (Subdivision EA of Division 7A).

Where a payment, loan or forgiveness of debt is treated as a deemed dividend, an unfranked dividend equal to the amount of the payment, loan or forgiveness of debt is generally included in the shareholder or associate's income.

Interactions between Division 6 and Division 7A generally arise where a trustee makes a corporate beneficiary presently entitled to income of the trust, but retains the amount for use in the trust (such as re-investing in a business) — creating an 'unpaid present entitlement'. If the trustee simply retained the amount it would be assessed at the top marginal rate (plus Medicare Levy). However, by

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57 Other than a trust taxed like a company under Division 6B (corporate unit trusts) or Division 6C (public trading trusts) of Part III.

58 Taxation Ruling IT 2680.

creating the ‘unpaid present entitlement’ the trustee, without the application of Division 7A, is effectively able to accumulate the amount at the corporate tax rate (currently 30 per cent).

The Government is continuing to monitor the application of Division 7A and, if appropriate, will review the operation of the Division through a separate process.

4.6 Division 6 and the new managed investment trust regime

On 7 May 2010, the Government announced the introduction of a new tax system for managed investment trusts (MITs) in response to recommendations by the Board in its report: *Review of the tax arrangements applying to managed investment trusts*.

As part of this new tax system, it is proposed that MITs in which unit holders have ‘clearly defined rights’ will be able to choose to use an attribution method of determining tax liabilities, rather than the current approach in Division 6.

It is proposed that under the attribution method, the trustee of a MIT will allocate the taxable income of the trust among beneficiaries on a fair and reasonable basis consistent with their clearly defined rights and the duties of the trustee. The beneficiaries of the MIT will then be assessable on the amount of taxable income of the trust that they are allocated by the trustee.

As proposed, the trustee will be taxed at the top marginal tax rate (plus the Medicare levy) on any taxable income that the trustee fails to allocate to beneficiaries within three months of the end of the income year.

Where a MIT does not choose (or is not eligible to choose) the attribution method, it will continue to be subject to Division 6. However, the effect of Division 6 will be modified to accommodate any aspects of the new tax system for MITs that are not restricted to MITs using the attribution method.

For example, it is proposed that all MITs will be able to carry forward ‘unders’ and ‘overs’ up to a *de minimis* threshold (primarily 5 per cent of the MIT’s taxable income) into the next income year without adverse taxation consequences.

4.7 Division 6 and the TFN withholding rules

The tax file number (TFN) withholding rules apply for unit trusts and closely held trusts (Divisions 4 and 4B of Part VA respectively).

The purpose of the TFN withholding rules is to improve the efficiency and effectiveness of the ATO's income matching system. Under this system, income reports are supplied to the ATO and then matched with the details disclosed by recipients in their tax returns.

The TFN withholding rules do not require a beneficiary to provide their TFN to the trustee of a trust. However, where a beneficiary decides not to disclose their TFN, the TFN withholding rules require the trustee to withhold from any payments at the top marginal rate (plus Medicare levy). Where this withholding results in too much tax being paid by the relevant beneficiary, the excess tax is refunded when the beneficiary submits their tax return for the relevant income year.

The TFN withholding rules operate on amounts that are determined under Division 6 and rely on Division 6 concepts such as ‘resident trust estate’ and ‘share of the income of the trust’.

It will therefore be necessary to update the TFN withholding rules to ensure that they reflect any relevant changes made to the operation of Division 6.

4.8 Division 6 and the trustee beneficiary reporting rules

Ultimate beneficiary reporting rules were introduced in 1999 as an integrity measure aimed at preventing complex chains of closely held trusts being used to avoid or indefinitely defer tax (Division 6D of Part III).

The rules were subsequently amended in 2007 so that trustees of closely held trusts no longer have to report to the Commissioner of Taxation (Commissioner) details of the trust's ultimate beneficiaries. Instead, trustees of closely held trusts are now only required to report to the Commissioner certain amounts to which trustee beneficiaries (that is, a beneficiary that holds their interest as trustee of another trust) are presently entitled.

Where required, if the trustee of a closely held trust does not make a correct trustee beneficiary statement in respect of a share of taxable income within the specified period, the trustee is liable to pay trustee beneficiary non-disclosure tax. This tax is levied on the untaxed part of the trustee beneficiary's share of taxable income at the top marginal tax rate plus Medicare Levy.

Failure to provide a correct trustee beneficiary statement within the specified period in respect of a trustee beneficiary's share of a trust's tax-preferred amounts may be an offence under the *Tax Administration Act 1953,* unless the trustee meets certain conditions.

5. OTHER ISSUES WITH THE OPERATION OF THE TRUST INCOME TAX PROVISIONS

This chapter identifies some of the other significant issues with the taxation of trusts that, whilst not strictly integral to the operation of Division 6, could nevertheless be addressed to provide greater certainty for taxpayers that use trusts.

As noted in section 1.3 the current issues with the legislative definition of 'fixed trust' will be examined through a separate process.

5.1 FIXED TRUSTS

The trust law contains a number of concessions that can only be accessed if a trust is a 'fixed trust' for the purposes of the income tax law. The key concessions relate to the ability of a trust to claim losses, access various CGT concessions and flow-through the benefit of franking credit tax offsets.

A trust is considered to be a 'fixed trust' for tax purposes where the beneficiaries of the trust have fixed entitlements to all of the income and capital of the trust.[59] That is, the beneficiaries of the trust must have a 'vested and indefeasible interest' in income or capital of the trust.[60] The Commissioner also has discretion to effectively treat a trust as 'fixed'.[61]

The recent decision in *Colonial* has highlighted that it may be difficult for most trusts to meet the strict definition of 'fixed trust', particularly where:

- the trustee has a power to issue or redeem units at a discount or premium;
- there are powers of amendment (including powers conferred by statute);
- the trustee has a power to classify receipts or outgoings as being income or capital in nature; or
- the trustee has (often wide) discretionary powers in 'exigent circumstances'.

In practice therefore, many trusts that operate on the basis that they are a 'fixed trust' either request the Commissioner to exercise his discretion to treat them as 'fixed', or effectively self-assess on that basis.

The Board recently examined the issues surrounding the definition of 'fixed trust' in its Report on the taxation of MITs.[62] In responding to this review, the Government agreed to treat MITs in which unit

59 Section 272-65 of Schedule 2F.
60 Subsection 272-5(1) of Schedule 2F.
61 Subsection 272-5(3) of Schedule 2F.
62 Board of Taxation, *Review of the Tax Arrangements applying to managed investment trusts — A report to the Assistant Treasurer,* Commonwealth of Australia, August 2009, Canberra. Recommendation 43 of the Board's Report was to deem a trust that qualifies as a 'Regime MIT' to be a fixed trust for all other provisions of the taxation law. Available at: <http://www.taxboard.gov.au/content/content.aspx?doc=reviews_and_consultations/managed_investment_trusts/default.htm&pageid=007>.

holders (beneficiaries) have 'clearly defined rights' as 'fixed trusts' for all other provisions of the tax law.[63]

Broadly, a MIT will satisfy the 'clearly defined rights' requirement if unit holders' rights to income (including the character of the income) and capital are clearly established at all times in the trust's 'constituent documents'. The rights should only be able to be changed by an amendment to the trust's constituent documents.

The Board also recommended that a general review of the fixed trust rules be undertaken with the aim of increasing certainty and reducing compliance costs for other unit trusts.[64] The Government has accepted this recommendation.[65]

5.2 TRUST LOSS RULES

The trust loss rules in Schedule 2F are designed to prevent the tax benefits that arise from the recoupment of trust losses from being transferred to persons who did not bear the economic impact of the loss when it was incurred.

To achieve this, the trust loss rules require trusts to satisfy a number of tests before claiming losses and debt deductions. For example, different tests apply depending on whether the relevant trust is a fixed trust, non-fixed trust or an 'excepted' trust.[66]

In addition to this initial classification, fixed trusts are further broken down into five categories: an ordinary fixed trust; an unlisted widely held trust; a listed widely held trust; an unlisted very widely held trust; or, a wholesale widely held trust. This classification depends on the number of beneficiaries the trust has as well as whether or not it is listed.

There are five tests that can apply to restrict the amount of losses that can be claimed by a trust:

- The 50 per cent stake test requires the same individuals to have fixed entitlements directly or indirectly to more than 50 per cent of the income and capital of the trust.
- The same business test broadly requires that at all times during the relevant 'test period' the trust carries on the same business it carried on immediately before the start of the test period.
- The pattern of distributions test applies to non-fixed trusts and broadly requires that the same individuals continue to be the major recipients of benefits from the trust.

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63 Former Assistant Treasurer the Hon Senator Nick Sherry, press release No. 86 of 7 May 2010, *New Tax system for Managed Investment Trusts.* Available at: <http://www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2010/086.htm&pageID=003&min=njsa&Year=&DocType=0>.

64 Board of Taxation, *Review of the Tax Arrangements applying to managed investment trusts — A report to the Assistant Treasurer,* Commonwealth of Australia, August 2009, Canberra, Recommendation 47. Available at: <http://www.taxboard.gov.au/content/content.aspx?doc=reviews_and_consultations/managed_investment_trusts/default.htm&pageid=007>.

65 Former Assistant Treasurer the Hon Senator Nick Sherry, press release No. 86 of 7 May 2010, *New Tax system for Managed Investment Trusts.* Available at: <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2010/086.htm&pageID=003&min=njsa&Year=&DocType=0>.

66 Broadly, a trust that receives concessional treatment under the trust loss rules, such as a 'family trust'.

- The control test requires that there is no change in control of a non-fixed trust during the test period.

- The income injection test seeks to identify schemes that have been used to facilitate income being injected into a trust with losses or other deductions.

With seven different types of trust and five different tests, this complexity can create significant uncertainty and additional compliance costs for trustees.

Updating the operation of the current trust loss rules would also provide an opportunity to examine whether the trust loss rules should be extended to capital losses. The recent case of *FCT v Clark*[67] highlighted the potential for 'capital loss trading' that exists because the trust loss rules do not extend to capital losses — in contrast to rules for other entities, such as companies.

However, the Government has also established a Business Tax Working Group to develop options to reform the treatment of tax losses for business more broadly. The principles underpinning any reform options might extend to trust losses (noting that not all trust losses are associated with business activity).

5.3 Family trust rules

The family trust rules generally provide 'family trusts' with concessional treatment for integrity rules, such as the trust loss rules[68], franking credit trading rules and the trustee beneficiary reporting rules. To be a family trust, the trustee must make a family trust election (Subdivision 272-D of Schedule 2F).

The election must specify a 'test individual' whose family group is the subject of the election. Generally, the test individual cannot be varied and the election cannot be revoked (with limited exceptions).

Where a trust is able to make a valid family trust election it will receive concessional treatment under the trust loss rules, provided distributions are made only to the family group.

If distributions are made to entities outside of the family group these distributions are subject to family trust distribution tax at the top marginal tax rate plus Medicare Levy.

There are a number of complex rules governing when a trust can make a family trust election, the entities that can form part of a family group (including companies, trusts and partnerships included through interposed entity elections) and whether a test individual can be varied.

In recognition of the increased use of trusts and the complexity of the arrangements put in place by many family groups, the Government welcomes comments on whether the family trust rules should be simplified as part of this process.

67 *Commissioner of Taxation v Clark* [2011] FCAFC 5.
68 The income injection test may still apply where income is injected from outside the family group.

6. POSSIBLE APPROACHES TO REFORMING DIVISION 6

This chapter examines at a broad conceptual level different approaches that could be adopted to reform the taxation of trust income. The chapter goes on to discuss the key components that are required in order to tax trust income.

6.1 A MINOR TUNE-UP OR A MAJOR SERVICE?

In announcing this update and rewrite of Australia's trust income tax provisions, the Government indicated its intention to retain the broad policy framework that currently applies to the taxation of trust income. That is, the taxable income of a trust will continue to be assessed primarily to beneficiaries, with trustees being assessed and liable to pay tax only to the extent that taxable income is not assessed to the beneficiaries.

Therefore, in rewriting the trust tax laws into the ITAA 1997, the question arises:

- should the existing model in Division 6 be broadly retained, with improvements to fix known problems and clarify uncertainties (discussed in Chapter 7); or
- should another model be adopted that makes more substantial changes but nevertheless delivers outcomes that are consistent with the current broad policy framework?

In considering this question, it is important to compare the benefits of any changes with the potential costs, including transitional costs.

6.2 CAN ONE SIZE FIT ALL?

There are a wide variety of trusts — differing in their deeds, structure, use and size (measured by the number of beneficiaries or value of assets held on trust). Trusts are commonly used as a vehicle for holding wealth (including for asset protection), carrying on business or investment activities, or a combination of both. Trusts are also used for family succession planning, including through the use of both inter vivos and testamentary trusts.

There are two contrasting ways of handling this variety for tax purposes.

First, the tax system could recognise different categories of trust and treat these in different ways.[69] This approach has been adopted in the United Kingdom where, for example, discretionary and accumulation trusts are taxed differently to non-discretionary trusts. Appendix B includes a brief summary of the different approaches that have been adopted internationally to trust taxation.

The key advantage of recognising different categories of trust is that it allows for more targeted tax outcomes.

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69 For example, the Government has already recognised the importance of providing certainty and reducing compliance costs for MITs and their investors by introducing a separate tax regime for these taxpayers.

However, this approach would also require clear rules about the different categories of trust, when and how any choices could be made, and ‘entry and exit’ rules setting out if and how trusts could move between categories (and any consequences for doing so). The need for these rules increases complexity and, unless the categories are clear, has the potential to create ‘border issues’ that may undermine any advantages of having more targeted tax outcomes.

Alternatively, the tax system could adopt an approach that is ‘robust to variety’. That is, the approach would provide appropriate tax outcomes regardless of the type or use of a specific trust. Where necessary, minor variations could be handled as an ‘add-on’, rather than complicating the core part of any model.

This approach would arguably deliver greater certainty and simplicity as trustees and beneficiaries would only be required to deal with one set of provisions.

However, as is demonstrated by the current operation of Division 6, it is unlikely that any one model would be able to produce the desired tax outcome for all types of trusts in all cases. Therefore a single model that achieves the desired outcome in the vast majority of cases and a ‘workable’ outcome in more unusual circumstances may be the best outcome that can be achieved under this approach.

Choosing between these two approaches requires a balancing of the advantages and disadvantages described above, in light of the policy principles set out in section 1.2.

6.3 Simplifying the link between trust and tax law

As part of any approach for taxing trust income, some interaction between trust and tax law is inevitable. However, the degree of interaction — and the problems created — can vary. Arguably, the tax system should interact as little as possible with trust law and allow flexibility in how people use trusts, whilst still meeting the policy principles outlined in section 1.2.

An approach that reduces the current reliance on specific trust deeds and trust concepts (which are often not well understood) as the basis for determining tax outcomes could dramatically reduce ongoing compliance costs for taxpayers, their advisers and the ATO.

Instead, the tax system could look to the economic benefits received by beneficiaries (such as distributions or entitlements) rather than the clauses in a trust deed.

6.4 The key elements of any approach to taxing trust income

Any model for taxing trust income must, at a minimum:

1. determine the tax components for a trust — including whether the trust should be recognised or ‘looked through’ for tax purposes;
2. determine who should be assessed on the taxable income of the trust; and
3. deal with unallocated (or accumulated) amounts and subsequent distributions.

Using this framework, Chapter 8 discusses three options for reforming the taxation of trust income.

6.4.1 Determining the tax components of a trust

Any model for taxing trust income must start by determining the tax components of a trust. This involves considering whether amounts should be treated as taxable income of the trust or of a beneficiary directly — that is, whether the trust should be 'looked through' for tax purposes.

The current income tax law identifies three basic tax components of trust income: taxable income, exempt income and non-assessable non-exempt income.

Consideration could also be given to introducing additional tax components of trust income — in effect, 'classes' of taxable income — for example, dividends, capital gains, business income, interest income, royalty income, foreign source income and other income.

Where a trust recognises the same classes of income for trust purposes as the tax system, this approach could allow for a simpler and fairer method for determining tax liabilities. However, where the trust classes and tax classes do not match, more complex rules could be required.

6.4.2 Determining who should be assessed on the taxable income of a trust

The 'core' of any model for taxing trust income is the mechanism by which the model determines who should be assessed on the taxable income of a trust. Without a robust mechanism for determining which amounts of the trust's taxable income should be assessed to each beneficiary (or the trustee), there is significant scope for anomalous outcomes and possible tax manipulation.

Consistent with the existing policy framework and the policy principles set out in section 1.2, the taxable income of a trust should be assessed to the entities that receive the (taxable) economic benefits from the trust. To achieve this it may be necessary to identify or determine, for the relevant income year:

- the 'trust amounts' that relate to the taxable income of the trust — which may or may not equal the trust definition of distributable income;
- to whom those trust amounts are distributed or allocated (or put another way, determining who is entitled to which amounts); and
- an appropriate link between entitlements to trust amounts and the taxable income that attaches to those amounts.

Trust amounts

Under the current operation of Division 6, the relevant trust amount that is the starting point for determining who should be assessed is the 'income of the trust estate'. As discussed in section 2.2, this amount is calculated with reference to general trust law principles, having regard to the provisions of the trust deed and appropriate accounting principles.

An alternative approach would be to create a statutory concept of the relevant 'trust amount'. For example, the 'streaming' changes introduced in TLAA No.5 2011 used the concept of the 'net financial benefit' referable to a capital gain or franked distribution.

As noted in section 1.1, the creation of a statutory definition of distributable income was previously explored in the March 2011 discussion paper —*Improving the taxation of trust income*, and

subsequently deferred for consideration as part of this process. The discussion paper included three options for statutorily defining the relevant 'trust amount'[70]:

- using tax concepts — for example, the interim changes in TLAA No.5 2011 used the concept of 'adjusted taxable income' to approximate the amount of income actually available for distribution from a trust;
- using accounting concepts; or
- broadly retaining the current approach of relying on general trust law principles and the trust deed, but specifically including capital gains.

Another option for defining the 'trust amount' would be to include all (net) realised gains of the trust, regardless of whether the gains are treated as income or capital of the trust. In many cases this would give the same trust amount as the concept of 'adjusted taxable income' above. However, there could be differences due to timing, or if some notional amounts were excluded from the adjustment.

However, whilst any move toward a statutory concept of 'trust amount' could create a better alignment between the 'trust amount' and the taxable income of a trust, the trust deed might not permit the trustee to distribute the whole of any amounts referable to this new 'trust amount'. The consequences of this would depend on how unallocated (or accumulated) amounts are treated.

Entitlements to trust amounts

Division 6 currently uses the concept of 'present entitlement' in determining the entitlements of beneficiaries and trustees for tax purposes (discussed in section 2.2).

The 'streaming' changes introduced in TLAA No.5 2011 used the concept of 'specific entitlement'. Broadly, the concept of 'specific entitlement' requires that a beneficiary has received, or can reasonably be expected to receive, the net financial benefit referable to a capital gain or franked distribution. This concept could be extended more broadly.

An alternative approach could be to use the concept of a 'distribution'. At the core of any definition of a 'distribution' is the idea that money (or property) is actually paid to or applied on behalf of a beneficiary. This concept would be consistent with the 'follow the money' principle outlined in section 1.2, provided that it involved more than a notional allocation.

The link between trust and tax amounts

The current link between trust and tax amounts is the 'proportionate approach', explained in section 2.2.

An alternative 'link' is the 'quantum approach', which would allocate taxable income to a beneficiary based on the (quantum) amount of their entitlement to trust amounts that relate to taxable income.

A key advantage of the 'quantum approach' is that it is relatively straightforward.

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70 The discussion paper used the term 'distributable income'. Arguably, 'trust amount' is a more useful term, as it recognises that the amount might not be treated under the trust deed as income, let alone *distributable* income.

However, the 'quantum approach' increases the likelihood of trustee assessments. For example, where the taxable income of a trust exceeds its distributable income, there may be a trustee assessment even when beneficiaries are entitled to all of the trust's distributable income. As above, the consequences of this would depend on how unallocated (or accumulated) amounts are treated.

6.4.3 The treatment of unallocated amounts and subsequent distributions

The way in which unallocated or retained amounts are treated can significantly influence the way trusts are used.

Under the current law, unallocated amounts (usually deliberate accumulations and 'accidental' unallocated amounts) are assessed to the trustee typically at the top marginal rate (plus Medicare Levy). Subsequent distributions of these amounts are generally not taxable.

If unallocated or retained amounts are taxed at relatively high rates as is currently the case, there is a strong incentive for trustees to ensure that beneficiaries are entitled to all of the trust's income each year. This tax treatment ensures that trusts are effectively used as flow-through vehicles even though the actual 'cash' within the trust may not actually be paid out to the relevant beneficiaries for a number of years.

Alternatively, if the trustee were taxed at a lower rate than the top marginal rate when some of the income is accumulated in the trust, there would be less incentive for the trustee to ensure that beneficiaries were made entitled to all of the trust's income. This tax treatment would increase the scope for trusts to be used more like accumulation vehicles, with amounts being taxed to the trustee and retained for use within the trust.

Whilst the taxation of trust income obviously has implications for the tax outcomes of beneficiaries and trustees, it is also necessary to consider the broader structural incentives that different approaches to the taxation of trust income may provide when considering any changes.

The Government welcomes comments on whether there are alternative approaches to the current treatment of unallocated amounts that balance efficiency, equity, simplicity and integrity concerns.

6.5 Transitional issues

The Government is aware that changes to the tax law can impose transitional costs on individuals who have structured their affairs under existing rules. For example, if significant changes are made to the trust income tax provisions, trustees may seek to amend their trust deeds to adapt to the updated law.

The size of any transitional costs will largely be determined by the approaches that are adopted in updating the trust income tax provisions.

The Government welcomes comments on appropriate transitional measures to ameliorate any harsh or unintended outcomes that may arise from the adoption of the options for reform canvassed in this paper.

7. CHANGES TO IMPROVE THE OPERATION OF DIVISION 6

This chapter examines a number of approaches to resolve some of the underlying issues with the current operation of Division 6. These issues arguably need to be considered regardless of the approach taken to determining who should be assessed on the taxable income of a trust (discussed in Chapter 8).

The Government welcomes comments on these issues and any other changes that would provide more certainty and clarity for the users of trusts.

7.1 CLARIFYING THE SCOPE OF THE TRUST INCOME TAX PROVISIONS

As discussed in section 3.1, the exact scope of Division 6 remains uncertain, particularly in relation to when a trust should be recognised for tax purposes.

There are broadly two approaches that could be adopted to provide more certainty about when Division 6 will apply to tax the beneficiaries or trustee of a trust.

First, the tax law could take an 'inclusion approach'. That is, a trust would be effectively 'looked through' for tax purposes, with the beneficiaries of the trust being assessed directly, unless the trust was specifically included within the scope of Division 6.

One way to implement an 'inclusion approach' would be to introduce a general principle into Division 6. Such a principle would not focus of the individual types of trusts but rather on the general characteristics of the trusts that should fall within the scope of Division 6.

Alternatively, a list approach could be adopted. Under this approach a comprehensive list outlining all of the different types of trusts that fall within the scope of Division 6 would need to be introduced into the tax law.

Second, the tax law could take an 'exclusion' approach. That is, the default position would be that a trust would be subject to the operation of Division 6, unless the trust was specifically excluded.

Again, a principled or list approach could be adopted to implement an 'exclusion approach'. However, the relevant principle would set out the characteristics of those trusts that would not be subject to the operation of Division 6. The relevant list would outline the types of trusts that would not fall within the scope of Division 6.

Under either an 'inclusion approach' or an 'exclusion approach' it should be relatively clear whether a trust is, or is not subject to Division 6. However, as with any distinction in the law there may be some level of uncertainty about the treatment of trusts that fall on the borderline of any rules. An appropriate mechanism may also need to be introduced into the tax law to deal with these situations.

Regardless of the approach taken, consideration could be given to applying the same rules for all purposes of the tax law, including the CGT regime and the GST. For example, if a trust were to be 'looked through' for the purposes of the trust income tax provisions, the beneficiary (or beneficiaries) would be treated as owning the assets of the trust directly for CGT purposes.

7.2 Extending the time for determining entitlements

Unless specified in a trust's deed, there is no trust law requirement that present entitlements be established by the end of an income year. However, as for all taxpayers, the income of beneficiaries (and trustees) is assessed on a year by year basis. Therefore, there must be some deadline for determining which beneficiaries should be assessed on a trust's taxable income for an income year.

As discussed in section 3.4, the requirement to create present entitlements by year end can create significant difficulties for trustees. This is largely because they may not have all of the relevant information about the trust's accounts at the time they are required to make their resolutions. Providing reasonable additional time could address these issues and reduce compliance costs.

However, any legislative extension of the deadline for determining the entitlements of beneficiaries would need to balance the benefits to trustees (such as having more information and time to prepare distribution statements) with the need for beneficiaries — including trustee beneficiaries — to determine their own tax affairs and lodge their returns.

Some stakeholders have argued that there could be different dates for some trusts (such as closely held trusts). Although this approach might better recognise the different needs of beneficiaries, multiple dates could also increase uncertainty and compliance costs.

The existence of default beneficiary clauses may add to the complexity of any reform options.

7.3 Providing certainty about character flow-through and streaming

As noted in section 3.5, the availability of character flow-through and 'streaming' are two areas of the tax law that continue to cause uncertainty for users of trusts.

Broadly, there are two different approaches that could be adopted to provide clarity about when amounts received through a trust retain their character for tax purposes.

First, the tax law could include a generic rule providing for character retention for amounts received through a trust. Where appropriate, this general rule could be limited by more specific provisions that remove a beneficiary's ability to claim concessions related to that character of income.

Second, the tax law could include specific rules to provide for character retention for specific types of income. In the absence of any specific rules, amounts received through a trust would have no particular character for tax purposes (other than as taxable income).

The effect of streaming for tax purposes would depend first on the approach taken for character retention. For example, if there was a general rule providing character retention, the amounts 'streamed' to a particular beneficiary would retain their character in the hands of the beneficiary.[71]

The effect of streaming also depends on whether an amount is 'allocated' to a beneficiary for tax purposes. Whether or not an amount is 'allocated' may depend on the broader approach that is taken to the allocation of taxable income (discussed in section 6.4 and Chapter 8).

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71 However, as noted above, specific provisions could remove the beneficiary's access to concessions attached to that income where appropriate.

It should be noted that the ability of a trustee to stream specific types of trust income to specific beneficiaries must come from the trust deed. In other words, the tax law does not give trustees a power to stream where they do not already have the power to do so.

In addition, trustees must also be able to identify the individual components of the trust's income in the trust accounts and resolutions — if only for evidentiary purposes.

7.4 Definite amendment periods for trustees

Under existing practices, the ATO does not issue a notice of assessment to a trustee unless there is a positive amount of tax for which the trustee is to be assessed. However, as noted in section 3.6, this technically allows the Commissioner to issue trustees with assessments a number of years after the tax affairs of the beneficiaries of the trust have otherwise been finalised.

In August 2007, the Treasury released a consultation paper that raised the idea of a legislative solution to this issue — that the Commissioner would only be able to raise an assessment within four years from the later of the due date or the actual lodgment date of the trust's return.[72]

This would provide trustees who had not received an assessment with a definite amendment period.

7.5 Clarifying the treatment of expenses

Broadly, the treatment of expenses could be dealt with in one of three ways.

First, specific legislative rules could be introduced that prescriptively govern the treatment of expenses, particularly where it is necessary to allocate them against different classes of income.

Second, a general legislative rule could be introduced to largely codify the existing common law principle that expenses should be apportioned on a fair and reasonable basis (without any ability for trust deeds to override it).

A third approach would be to maintain the status quo. Broadly, this would result in expenses continuing to be attributed on a 'fair and reasonable assessment of the extent of the relation of the outlay to assessable income', possibly subject to the terms of the trust deed.

The most appropriate way to treat expenses may depend on the approach taken to other issues, particularly in relation to determining who should be assessed on the taxable income of a trust, as well as character flow-through and 'streaming'.

7.6 Clarifying the scope of section 99B

As outlined in section 3.7, there is a substantial difference between the intended scope of section 99B (as reflected in the explanatory memorandum accompanying its introduction) and its much wider potential scope.

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72 Treasury discussion paper, August 2007 — *Review of unlimited amendment periods in the income tax laws*. Available at: <http://www.treasury.gov.au/contentitem.asp?NavId=037&ContentID=1298>.

In the broader update and rewrite, this integrity provision could be clarified to ensure it better reflects its intended scope.

7.7 Separate rules for taxable, exempt and non-assessable non-exempt income

As outlined in section 3.8, the treatment of taxable, exempt and non-assessable non-exempt income under a single subsection with common introductory words can arguably create anomalous outcomes.

Under any updated version of Division 6, these three categories of income could be treated separately.[73] This approach would avoid confusion about the interaction between taxable, exempt and non-assessable non-exempt income — and ensure that exempt and non-assessable non-exempt income are allocated appropriately where there is no taxable income of a trust.

However, as with the treatment of expenses, the most appropriate way to implement this separation may depend on the approaches taken to address other issues with the trust income tax provisions.

73 For example, existing paragraphs 97(1)(b) and 97(1)(c) could be converted into stand alone subsections with references to a beneficiary's present entitlement to a share of the exempt income and non-assessable non-exempt income of the trust respectively (rather than the income of the trust estate).

8. Options for reforming the taxation of trust income

This chapter outlines three models for reforming the taxation of trust income. These are the:

- ‘patch’ model;
- ‘proportionate within class’ model; and
- ‘trustee assessment and deduction’ (TAD) model.

Each of these models has the potential to build upon the improvements discussed in Chapter 7.

The Government invites stakeholders to comment on each of the models and, if appropriate, propose other options for reform.[74]

8.1 Patch model

The ‘patch’ model is arguably the least intrusive way to update the operation of Division 6. It involves retaining the existing structure of Division 6, but defining the term ‘income of the trust estate’ for tax purposes.

Under the current operation of Division 6 there is significant scope for anomalous outcomes and possible tax manipulation due to mismatches between the terms ‘income of the trust estate’ and ‘net income of the trust estate’.

This issue was discussed extensively as part of the Treasury discussion paper, *Improving the taxation of trust income*, released on 4 March 2011. After highlighting the current issues with the existing operation of the ‘proportionate approach’ the paper outlined three options to more closely align the definitions of the terms ‘income of the trust estate’ and ‘net income of the trust estate’ for tax purposes. These options involved defining the term ‘income of the trust estate’ by:

- using tax concepts — similar to the concept of ‘adjusted taxable income’ used in the specific anti-avoidance rules introduced in TLAA No.5 2011;
- using accounting concepts; or
- retaining the current approach of relying on general trust law principles and the trust deed, but specifically including capital gains.

The submissions received in response to that discussion paper indicated that the preferred approach to defining the term ‘income of the trust estate’ as part of a ‘patch’ model was to use tax concepts.

As was highlighted in section 2.2.1 of that discussion paper, defining ‘income of the trust estate’ using tax concepts would require adjustments to be made to the concept of taxable income to better reflect the actual amount available for distribution to the beneficiaries of the trust (that is, to account for both notional income and expense amounts).

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[74] The Government has ruled out taxing trusts as companies as it would be a major departure from the current policy framework.

Following the introduction of a workable definition of 'income of the trust estate' based on tax concepts, there would be significantly less scope for tax manipulation based on the deliberate creation of a mismatch between distributable and taxable income as it would be necessary to apply the 'proportionate approach' to largely similar amounts.

The treatment of expenses under the 'patch' model could be dealt with in any of the three ways canvassed in Chapter 7. Alternatively, the treatment of expenses could be built into the definition of distributable income.

In addition, the approach adopted in defining distributable income would have to be mirrored for exempt income and non-assessable non-exempt income to overcome the currents issues with the operation of section 97.

Appendix A contains a worked example demonstrating how the 'patch' model could be made to work in practice.

8.2 Proportionate within class model

A variation of the existing model in Division 6 is the 'proportionate within class' model. A 'class' is a grouping of trust amounts of a certain type (discussed further below).

This model operates in a similar way to the current present entitlement model in determining the income tax liabilities of the trustee and beneficiaries of a trust. However, there is an additional step to ascertain the classes of income — and the proportionate entitlement in relation to these classes.

In short, rather than being assessed on a proportionate share of the taxable income of the trust, a beneficiary would be assessed on a proportionate share of so much of the taxable income of each class. If there is only one class of income, then the 'proportionate within class' model operates in the same way as the current model.

Broadly, the steps in this model are:

- determine the trust's distributable income (as discussed in section 6.4);
- determine the different classes of income that the trustee will maintain;
- allocate the trust's distributable income to these different classes of income;
- calculate the taxable income of the trust;
- allocate the trust's taxable income to the classes maintained by the trustee; and
- determine the share of the relevant beneficiaries to each class of taxable income based on their proportionate entitlement to that class of trust's distributable income.

8.2.1 Classes of Income

The different classes of income could be determined in two ways.

First, the classes could be determined with reference to the trust's deed. The classes would not necessarily need to reflect the different classifications of income made by the tax law such as dividends, interest, royalties, etc. For example, there could be two classes for a trust: investment income and business income.

However, if the classes were determined with reference to the trust's deed, the 'proportionate within class' model would likely need a definition of distributable income as discussed in the 'patch' model (section 8.1).

Second, the classes could be set out for tax purposes within the tax law and would not depend on how the amounts are treated in the trust deed.

Again for example, there could be two classes: capital income (that is, amounts calculated under the CGT provisions) and revenue income (all other amounts). Or there could be more, such as capital income, interest income, dividend income, primary production income and all other income.

If a trustee maintains classes of income that correspond with the classifications made by the tax law, it may prove easier for the trustee to determine the amounts of the trust's taxable income on which the trustee and the beneficiaries of the trust are liable to pay tax. It would also provide a better basis for determining character flow-through of amounts through a trust.

Regardless of what approach is taken, trustees would be required to keep accounts and records showing how the income of each class is allocated to beneficiaries.

8.2.2 Allocating the distributable income to these classes

A trustee would then allocate the (total) distributable income of the trust to the various classes.

Allocating an amount into a specific class would not change the character of the amount for tax purposes. The action of allocating should be seen merely as an exercise of fairly and reasonably segregating these amounts to their predetermined pools.

Under the 'proportionate within class' model, legislative rules on the treatment of expenses would arguably be more important (see section 7.5). The rules would need to cover specific expenses (those incurred to earn income of a specific class) and general expenses.

8.2.3 Taxable income

The calculation of a trust's taxable income under this model could continue to be made with reference to the existing approach in Division 6 (section 95).

The trustee would then be required to separate and allocate the components of the trust's taxable income into the various classes of income.

The fifth policy principle states that trust losses should generally be trapped in trusts. There would need to be further consideration of how to treat losses at a class level if a 'proportionate within class' model was adopted.

8.2.4 Calculating the tax liabilities of beneficiaries and trustees

Under this model, the tax liabilities of the trustees and beneficiaries of the trust are determined with reference to the present entitlement to a share of each class of income.

Beneficiaries

For each class of income, beneficiaries would be assessed on their proportionate share of the taxable income of that class, based on their entitlement to trust amounts of that class.

Where a class contained income of more than one character, beneficiaries would be assessed on their proportionate share of each type of income in that class.

Trustees

Trustees would be liable to tax on their proportionate share of each class of taxable income corresponding to the share of that class of income to which no beneficiary was presently entitled.

8.2.5 Why adopt a 'proportionate within class' model

The adoption of a 'proportionate within class' model to update the operation of Division 6 would arguably provide continuity as the model builds on existing concepts that many taxpayers and tax professionals are familiar with. Consequently, there may be less transitional costs associated with informing both trustees and beneficiaries of their obligations under this model.

Further, the model provides a better basis for determining character flow-through and the potential streaming of different amounts of a trust's taxable income.

However, as the model still relies on trust law concepts and the need to interpret individual trust deeds it retains a number of the issues associated with the current application of Division 6. Thus, it may not actually result in a reduction in the current complexity of the law.

For trusts that do not currently distinguish between classes of income, the model may actually increase complexity and compliance costs. Such trusts may need to modify their trust deeds and keep more detailed records in order to comply with the model.

In addition, depending on the approach taken to defining classes, the adoption of this model may require a definition of 'distributable income' (similar to the 'patch' model).

An example of how this model might operate is provided in Appendix A.

8.3 Trustee assessment and deduction model

Another alternative to the current approach is a TAD model, similar to the models adopted in the United States, Canada and New Zealand.

A TAD model is one where the taxable income of a trust is assessed in the hands of those beneficiaries that receive the economic benefits related to that taxable income. Assessable amounts

that are not distributed by a certain time (or taxable income with no underlying economic benefits capable of distribution) are taxed in the hands of the trustee.

A TAD model is therefore directly consistent with the first policy principle for taxing trust income — that tax liabilities in respect of the income and gains of a trust should 'follow the money'.

The model is effectively a 'quantum approach' based on distributions of taxable income[75] rather than a concept of 'entitlement' to income.

By clearly defining key concepts and reducing the reliance of the tax law on individual trust deeds, the model also supports the second and third policy principles — that the tax law should be conceptually robust, more certain and simpler.

Consistent with the fourth policy principle, a TAD model could clearly state whether amounts retain their character and source when they are distributed to beneficiaries.

The building blocks underlying a TAD model are:

- calculating the taxable income of the trust and other tax components such as exempt income and non-assessable non-exempt income (as discussed in section 6.4.1);
- identifying those parts of the trust's taxable income that have been distributed to beneficiaries of the trust;
- calculating the tax liabilities of the beneficiaries; and
- determining the treatment of unallocated amounts and subsequent distributions.

8.3.1 What is a distribution?

As highlighted above, the TAD model provides a deduction to the trustee for distributions of taxable income to the beneficiaries of the trust. If the trustee distributes all of the taxable income, no tax is payable by the trustee.

The definition of a distribution (and whether it is deductible) is therefore critical.

Broadly, a 'distribution' to a beneficiary might include:

- an actual payment of cash or property to a beneficiary (in their capacity as a beneficiary); and
- an application of cash or property for the benefit of, or at the direction of a beneficiary (in their capacity as a beneficiary).

A distribution would be deductible for an income year if it was made by a specific date after the end of the income year (see section 7.2 for a discussion of this issue). The size of the deduction would reflect the taxable income related to the amount distributed (including, for example, a gross-up for attached franking credits).

75 Strictly speaking, the distribution would be of trust amounts *related* to taxable income. In some cases, there could be a difference between the trust amount and the related taxable income — such as in the case of discount capital gains.

While this general approach may produce the right outcome in the majority of cases, consideration may still need to be given to whether there are certain amounts that should not be treated as deductible distributions. Such amounts might include payments made pursuant to a reimbursement agreement in the context of 'trust stripping' (see, for example, section 100A).

8.3.2 Calculating the tax liabilities of beneficiaries

The beneficiaries of the trust would be assessable on (taxable) distributions they receive or that are applied for their benefit. The taxable amount would typically equal the deduction for the trustee.

To provide certainty in relation to character and source, a TAD model could have a general principle that all amounts distributed in the year they are first recognised for tax purposes would retain their character and source in the hands of beneficiaries. Some exceptions may be necessary, such as where beneficiaries hold their interests in a trust on revenue account.

Trustees would continue to be bound by the powers provided by their trust deed. In other words, the general principle would give effect to 'streaming' where the trustee has the power to do so, rather than conferring the power to stream.

8.3.3 The treatment of unallocated amounts and subsequent distributions

As described above, the trustee of a trust would be assessed on the taxable income of the trust after allowing for a deduction for (deductible) distributions to beneficiaries. If a trustee distributes all of the taxable income of a trust, they would not be liable to pay tax on any portion of the taxable income.

Broadly, this ensures that trustees are only assessed on taxable amounts that are retained in the trust.[76]

However, the TAD model may increase the scope for trustee assessments — both for intentional accumulations and unintentional unallocated amounts (such as if there is an error in the calculation or distribution of amounts or because there were insufficient funds available for distribution).

This result highlights the importance of treating unallocated amounts in a way that balances efficiency, equity, simplicity and integrity concerns (as discussed in section 6.4.3).

8.3.4 Why adopt a TAD model?

A TAD model has a number of potential benefits as it:

- reduces complexity and compliance costs by avoiding the need to apply detailed trust concepts such as 'income of the trust estate' and 'present entitlement' in order to determine the tax liabilities of the beneficiaries and trustees of the trust;
- reduces the reliance on individual trust deeds. Currently, the 'income of a trust estate' can be as varied as trust deeds themselves;

76 As currently occurs, the trustee could be assessed primarily as a collection mechanism in respect of amounts otherwise assessed to beneficiaries, such as non-residents and minors (under section 98).

- defines key concepts and reduces the need to apply trust concepts; and
- reduces the scope for beneficiaries to be taxed on amounts that they are not entitled to under trust law.

On the other hand as this model relies on a quantum approach, it may increase the scope for trustee assessments (although there may be options to address this).

Further, as this model represents a significant departure from the current operation of Division 6, there may be additional costs associated with the need to inform and educate trustees and beneficiaries about their new obligations. Additional costs may also be incurred if it is necessary for trusts to amends their deeds in order to adapt to the new laws.

An example of how this model might operate is provided in Appendix A.

QUESTIONS FOR CONSULTATION

The Government invites interested parties to provide comments and feedback on any aspect of this consultation paper — in particular the options for reform outlined in Chapters 7 and 8.

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

1. Do the policy principles outlined in Chapter 1 accurately reflect the existing framework for the taxation of trusts?

2. The Government has identified a number of areas of the trust income tax provisions that require immediate reform. Are these the areas in most need of immediate reform? If not, what areas should the Government seek to reform as a priority?

3. Should the trust income tax provisions be updated and rewritten as part of a single process or would it be more appropriate to conduct this reform through a staged approach?

4. Uncertainty about the scope of Division 6 is arguably one of the key issues hampering the effective taxation of trust income. If the scope of Division 6 is clarified, under either an inclusion or exclusion approach, should a general principle or a comprehensive list be adopted?

5. What types of trust might it be appropriate to carve out of the operation of Division 6? Are there any other areas of the tax law where a similar carve out for these types of trust may or may not be appropriate?

6. Is there sufficient uncertainty with the current treatment of expenses to warrant a legislative solution?

7. If the concept of distributable income is to be defined using tax concepts, what adjustment will need to be made to existing tax concepts to allow for a workable definition?

8. Should character flow-through and 'streaming' be provided on a general basis with specific limitations or alternatively through the use of specific provisions? If 'streaming' is provided using specific provisions, in addition to capital gains and franked distributions what other types of income should be afforded this treatment?

9. How should losses be dealt with where character flow-through of different classes of income is recognised?

10. In addition to those areas of the tax law highlighted in Chapter 4, are there any other areas that may need to be updated if changes are made to the current operation of Division 6?

11. Are there issues with the operation of the provisions highlighted in Chapter 4 that may need to be addressed, in addition to any changes that may need to be made to ensure that these provisions are able to operate effectively with an updated version of Division 6?

12. Should there be one generic or multiple targeted tax regimes for the taxation of trust income? If a generic regime is desirable, which of the three approaches outlined in Chapter 8 should be adopted? Are there any other models that could be considered in updating the operation of Division 6?

13. If a 'proportionate within class' model was adopted would it be necessary to define the concept of distributable income in the same ways as outlined under the 'patch' model?

14. As highlighted in Chapter 8 the adoption of a TAD model may result in increased trustee assessments. If a TAD model was adopted is there an appropriate way to reduce the potential effects of the top marginal tax rate applying to unallocated amounts?

15. If a TAD model was adopted, how should the tax law define the concept of a 'distribution'?

16. If significant changes are made to the current operation of Division 6 what transitional measures do you consider the Government may need to provide?

ABBREVIATIONS

GST	Goods and Services Tax
CGT	Capital Gains Tax
Commissioner	Commissioner of Taxation
MIT	Managed Investment Trust
TAD Model	Trustee Assessment and Distribution Model
ITAA 1936	*Income Tax Assessment Act 1936*
ITAA 1997	*Income Tax Assessment Act 1997*
ATO	Australian Taxation Office
TDAP	Tax Design Advisory Panel
Board	Board of Taxation
TFN	Tax file number

Appendix A: Examples of the operation of the patch model, the proportionate within class model and the trustee assessment and deduction model

The following examples demonstrate the possible operation of the 'patch' model, the 'proportionate within class' model and the 'trustee assessment and deduction' model outlined in Chapter 8 of this consultation paper. The examples provide indicative outcomes based on the following facts:

The trustee of the Caulfield Trust exercises its discretion to appoint its income to its resident beneficiaries, Arnold and Steven.

As a result of the appointment, Arnold is presently entitled to all interest, dividends, trust distributions and rent income, and Steven is presently entitled to all business income and capital gains. The profit and loss statement and tax return of the trust are as follows:

Description	Profit and loss statement: $	Tax return: $
Interest from term deposit	100	100
Franked dividend from listed shares (excluding franked credit)	700	700
Franking credit	0	300
Unfranked dividend from listed shares	500	500
Trust distributions from unlisted property trusts(a)	800	0
Rent income from rental property	1,000	1,000
Business income	10,000	10,000
Capital gain(b)	20,000	5,000
Total Income	33,100	17,600
Interest on loan to acquire property	(300)	(300)
Business expenses(c)	(3,000)	(5,000)
Total Expense	(3,300)	(5,300)
Trust Income/Net Income	29,800	12,300

(a) The distribution statement stated that all of the distribution was tax deferred income, and the trustee of the Caulfield trust did not otherwise consider these distributions to be ordinary income.
(b) The gross capital gain $20,000 was from a disposal of active assets in business. Assume that the trustee of the Caulfield trust was entitled to apply both Subdivision 152C and Division 115 of the ITAA 1997.
(c) The difference in these amounts was attributable to the notional amount arising from Division 43 of the ITAA 1997 deductions for capital works.

Patch Model

In this illustration of the 'patch' model, the distributable income of the trust is defined as equal to the taxable income of the trust (section 95 net income), modified by:

- notional amounts such as franking credits, which are excluded for this purpose;
- notional expenses such as Division 43 deductions for capital works, which are disregarded (but only for this purpose); and

- discounted capital gains are grossed up to the value of their real accretion to the trust estate.

Therefore, the distributable income[77] for the Caulfield trust would be:

Interest from term deposit	100
Franked dividend (excluding franking credits)	700
Franking credits	0
Unfranked dividend	500
Trust distributions	0
Rent income	1,000
Business income	10,000
Grossed up capital gain	20,000
Total Income	32,300
Interest	(300)
Business expenses	(3,000)
Total Expense	(3,300)
Total	29,000

Ignoring the effect of Division 6E of Part III (Division 6E), Arnold would be taken to be presently entitled to $2,000 and Steven to $27,000, as follows:

	Arnold: $	Steven: $
Interest from term deposit	100	0
Franked dividend from listed shares	700	0
Franking credits	0	0
Unfranked dividend from listed shares	500	0
Trust distributions	0(a)	0
Rent income from rental property	1,000	0
Business income	0	10,000
Capital gain	0	20,000
Total Income	2,300	30,000
Interest on loan to acquire property	(300)	0
Business expenses	0	(3,000)
Total Expense	(300)	(3,000)
Total	2,000	27,000

(a) Even though Arnold is entitled to the trust distributions, they do not form part of the distributable income of the Caulfield trust as defined, not being part of its section 95 net income.

77 The calculation of distributable income would ignore any effect from Division 6E, as that Division only modifies the amounts assessed under Division 6.

However, in this example, Arnold is specifically entitled to the franked distributions as defined under section 207-58 of the ITAA 1997 and Steven is specifically entitled to the capital gain as defined under section 115-228 of the ITAA 1997.

Therefore, for the purposes of applying Division 6E, the following table represents the income of the trust disregarding the franked distributions and capital gains.

Present entitlement to 'adjusted income'	Arnold: $	Steven: $
Interest from term deposit	100	0
Franked dividend from listed shares	0	0
Franking credits	0	0
Unfranked dividend from listed shares	500	0
Trust distributions	0	0
Rent income from rental property	1,000	0
Business income	0	10,000
Capital gain	0	0
Total Income	1,600	10,000
Interest on loan to acquire property	(300)	0
Business expenses	0	(3,000)
Total Expense	(300)	(3,000)
Total	1,300	7,000

Arnold's 'adjusted Division 6 percentage'[78] would be 15.66 per cent ($1,300/$8,300) and Steven's 'adjusted Division 6 percentage' would be 84.34 per cent ($7,000/$8,300).

The trust's Division 6E net income would be its taxable income ($12,300) reduced by any franked distributions ($700), attached franking credits ($300), and net capital gain ($5,000), that is, $6,300.

Under this approach, Arnold would have an assessable income of $1,986.75. The figure is made up of $986.75 (15.66 per cent of $6,300) assessable under section 97 (as modified by Division 6E) and $1,000 (including $300 franked credits) assessable under Subdivision 207-B of the ITAA 1997.

Steven would have an assessable income of $10,313.25. The figure is made up of $5,313.25 (84.34 per cent of $6,300) assessable under section 97 (as modified by Division 6E) and an extra capital gain of $5,000 under Subdivision 115-C of the ITAA 1997. Consistent with the current law, Steven would gross up the capital gain to $20,000, apply any capital losses, apply the general CGT discount and then apply the small business 50 per cent reduction.

78 That is, the percentage of the distributable income of the trust to which the beneficiary is presently entitled, disregarding any capital gains or franked distributions to which any beneficiary is specifically entitled.

Assessable amount	Arnold: $	Steven: $
Interest from term deposit	15.66	84.34
Franked dividend from listed shares (excluding franked credit)	700.00	0
Franking credits	300.00	
Unfranked dividend from listed shares	78.31	421.69
Trust distributions	0	0
Rent income from rental property	156.63	843.37
Business income	1,566.27	8,433.73
Capital gain	0	5,000.00
Total Income	2,816.87	14,783.13
Interest on loan to acquire property	(46.99)	(253.01)
Business expenses	(783.13)	(4,216.87)
Total Expense	(830.12)	(4,469.88)
Total	1,986.75	10,313.25

If neither Arnold nor Steven were specifically entitled to any particular class of income, then Arnold's adjusted Division 6 percentage would be 6.9 per cent ($2,000/$29,000) and Steven is 93.1 per cent ($27,000/$29,000)

Arnold would have assessable income of $848.28 (6.9 per cent of $12,300) and Steven would have assessable income of $11,451.72 (93.1 per cent of $12,300) of all classes of taxable income.

Assessable amount	Arnold: $	Steven: $
Interest from term deposit	6.90	93.10
Franked dividend from listed shares (excluding franked credit)	48.28	651.72
Franking credits	20.69	279.31
Unfranked dividend from listed shares	34.48	465.52
Trust distributions from unlisted property trusts	0	0
Rent income from rental property	68.97	931.03
Business income	689.66	9,310.34
Capital gain	344.83	4,655.17
Total Income	1,213.81	16,386.19
Interest on loan to acquire property	(20.69)	(279.31)
Business expenses	(344.83)	(4,655.17)
Total Expense	(365.52)	(4,934.48)
Total (a)	848.28	11,451.72

(a) slight variation due to rounding

Proportionate within class model

Under this model, taxable income of a particular class would be assessed in the hands of beneficiaries in the same proportion as their entitlement to benefit from that class (with any unallocated proportion assessed to the trustee).

The following example is based on defining three classes of income: 'capital income' (that is, amounts calculated under the CGT provisions), 'business income' and 'other revenue income' (all other amounts). Further, the distributable income is defined as for the patch model above.

Arnold is presently entitled to all of the 'other revenue income' class.

Steven is presently entitled to all of the 'capital income' class and all of the 'business income' class.

Class 1 — Other revenue income	Distributable income: $	Trust return: $
Interest from term deposit	100	100
Franked dividend excluding franking credit	700	700
Franking credits	0	300
Unfranked dividend	500	500
Trust distributions	0	0
Rent income	1,000	1,000
Total Income	2,300	2,600
Interest	(300)	(300)
Total Expense	(300)	(300)
Total	2,000	2,300

From 'other revenue income' class, Arnold would have an assessable income of $2,300 (2,000/2,000 x $2,300) per the above table.

Class 2 — Business income	Distributable income: $	Trust return: $
Business income	10,000	10,000
Business expenses	(3,000)	(5,000)
Total	7,000	5,000

From 'business income' class, Steven would have an assessable income of $5,000 (7,000/7,000 x $5,000) per the above table.

Class 3 — Capital Income	Distributable income: $	Trust return: $
Capital gain	20,000	5,000
Total	20,000	5,000

From 'capital income' class, Steven would have an assessable income of $5,000 (20,000/20,000 x $5,000) per the above table.

Trustee assessment and deduction model

Under this model, the trustee is assessed on the taxable income of the trust after allowing for a deduction for distributions of taxable income to beneficiaries. This model is effectively a quantum approach based on distributions of taxable income rather than a concept of entitlement to income.

Accordingly, for the trustee of the Caulfield Trust, the trustee would be assessed as follows:

Calculated net income(a)	12,300	
Less 'deductible distributions' to Arnold		
Interest from term deposit	(100)	
Franked dividend from listed shares(b)	(700)	
Franking credits(b)	(300)	
Unfranked dividend from listed shares	(500)	
Trust distributions from unlisted property trusts(c)	0	
Net rent income from rental property	(700)	
		(2,300)
Less 'deductible distributions' to Steven		
Net business income	(5,000)	
Net capital gain(d)	(5,000)	
		(10,000)
Trustee's taxable income	0	

(a) See Table 1 to this appendix
(b) The deduction for the distribution of the franked dividend is grossed up to $1,000 to reflect the attached franking credits.
(c) The 'deductible distribution' was $Nil. The distribution was $800. The financial benefit which flew to Arnold was $800; however none of this amount was referable to the trust's taxable income.
(d) The 'deductible distribution' was $5,000. The distribution to Steven was $20,000, however only $5,000 out of this amount was referable to the trust's taxable income.

Arnold would have assessable income of $2,300, including a $300 franking credit from the franked dividend.

Steven would have assessable income of $5,000 and an extra capital gain of $5,000. As above, Steven would gross up the capital gain to $20,000, apply any capital losses, apply the CGT discount, and then apply the small business 50 per cent reduction.

Taxable income of a trust exceeds the amount available for distribution

In the following example, the taxable income of the Deakin Trust exceeds the amount available for distribution. This arises because the trustee incurs an expense that is not deductible (but instead adds to the cost base of assets held by the trustee).

The beneficiary received all of the $10,000 of distributable income of the trust. Without any modification to the model, the trustee would be assessed on $40,000.

The profit and loss statement of The Deakin Trust	
Business income	50,000
Less legal expense (a)	(40,000)
Total trust income	10,000

(a) The legal expenses in this example are not deductible under section 8 1 of ITAA 1997, because, say, the expenditures incurred in defending the value of the goodwill of the business.

Total taxable income of the Deakin Trust	50,000
Less 'deductible distributions' to beneficiary of the Deakin Trust	(10,000)
Trustee's taxable income	40,000

APPENDIX B: SUMMARY OF KEY FEATURES OF OTHER TRUST REGIMES

UNITED STATES OF AMERICA

Trust structure

Trusts in the United State of America (USA) are generally divided into 'simple', 'complex' and 'grantor' trusts.

- A 'simple' trust is a trust that is required to distribute all of its income, but does not distribute capital or make charitable contributions.
- A 'complex' trust is any other trust.
- A 'grantor' trust is a trust in which the settlor retains the power to control the trust's income or assets.

A distinction is also made between 'domestic' and 'foreign' trusts.

What are trusts primarily used for?

Trusts are mainly used in the USA for personal matters (such as asset protection and succession planning), business matters, real-estate investment, pension funds and profit-sharing arrangements.

Taxable income

The taxable income of a trust is generally determined in the same manner as that of an individual.

Attribution method

In the USA, trusts are taxed in a similar way to individuals, but are allowed a deduction for amounts distributed to beneficiaries. As a result, trusts are only taxed on income that is retained or allocated to capital in a relevant income year. The relevant tax rate applied to these amounts is 40 per cent (for the 2011-12 income year).

To the extent that a trust's taxable income is distributed, those amounts are taxable to the beneficiaries of the trust at their individual tax rates.

The critical amount that needs to be established in determining the tax liabilities of a trust and its beneficiaries is the trust's distributable net income. This amount limits the size of the deduction that a trustee can claim for distributions to the trust's beneficiaries and hence also determines the size of any retained amount.

The distributable net income of a trust is generally its taxable income modified for capital gains, or losses, tax-exempt interest and certain amounts that are allocated to capital.

Character retention

In general, any income allocated to a beneficiary retains the same character in the beneficiary's hands as it had in the hands of the trustee.

To the extent income is not deemed distributed, the character of the income is allocated between the trust and the beneficiary according to the governing instrument or the relevant state law.

CANADA

Trust structure

Trusts are broadly categorised into testamentary or inter vivos trusts, which are treated differently for tax purposes.

- Testamentary trusts are personal trusts that are created on the day that a person dies. The terms of the trust are set out according to the will or court order in relation to that person's estate.

- An inter vivos trust is any trust that is not a testamentary trust.

In certain circumstances, such as when assets of a trust are not distributed to the beneficiaries of that trust in accordance with the terms of the relevant will, a testamentary trust may be treated as an inter vivos trust.

Different types of inter vivos trusts include specified investment flow-through trusts, unit trusts, personal trusts and non-profit organisation trusts.

What are trusts primarily used for?

Trusts are used for a variety of purposes including real estate and share market investments, asset protection and succession planning.

Taxable income

Trusts are taxed as individuals, without the benefit of personal income tax credits.

Attribution method

Broadly, a trustee is subject to tax on all of the trust's income, apart from income that is currently distributable to beneficiaries.

An amount is currently distributable to a beneficiary if it has actually been paid to the beneficiary, or the beneficiary is entitled to enforce the payment of the amount. In the case of a discretionary trust, an amount becomes distributable to a beneficiary only when the trustee exercises their discretion to allocate the income to the beneficiary, so that the beneficiary may enforce its payment.

Income distributed to a beneficiary is taxed at the beneficiary's rate of tax.

Any amounts that are not distributed to beneficiaries are 'undistributed income'. These amounts are taxed to the trustees of a trust at graduated personal tax rates if the trust is a testamentary trust and at the highest personal tax rate if the trust is an inter vivos trust.

Losses are generally trapped in trusts but can be carried forward and offset any future undistributed trust income.

Character flow-through

Certain types of income, such as dividends, interest and taxable capital gains may retain their character when paid to beneficiaries. Otherwise, income is deemed to be income from a property that is an interest in a trust, and not from any other source.

United Kingdom

Trust structure

The United Kingdom (UK) provides for a number of trust structures including bare trusts, discretionary trusts, accumulation trusts, employee benefit trusts, charitable trusts, investment and unit trusts, parental trusts and non-resident trusts.

What are trusts primarily used for?

Generally, each of the different trust structures allowed for under the law is used for a discrete purpose, including:

- Discretionary trusts — trustees can choose whether or not to pay out trust income and to whom. Discretionary trusts are often used for succession planning.
- Accumulation trusts — trustees accumulate income and add it to the trust capital until the beneficiaries become legally entitled to the trust assets.
- Employee benefit trusts — employers can set up schemes for the benefit of their employees.
- Charitable trusts — a charitable trust is a type of trust set up for a cause or purpose that will benefit a large group of people or society in general, not specific individuals.
- Investment trust companies and unit trusts — investment trust companies are companies that invest in the share of other companies. Unit trusts are a form of 'pooled investment' where a fund manager buys shares in a range of different companies and pools these in a fund.
- Parental trusts for children allow parents to set up trusts for unmarried children below the age of 18.
- Non-resident trusts — UK trusts can be set up or managed by people living abroad.

Taxable income

Trustees are liable to pay tax on income (such as dividends or business income) and capital gains from the disposal of trust assets.

Attribution method

The tax consequences that apply to both the beneficiary and trustee of a trust depend on the specific type of trust.

Non-discretionary trusts

For non-discretionary trusts, trustees will pay tax at 10 per cent on dividend type income and 20 per cent on all other income.

Trustees are also generally liable to pay tax at 28 per cent on any capital gains made by the trust which exceed £5,300 (for the 2011-12 income year).

Beneficiaries are liable to pay income tax on the difference between their personal tax rate and the rate of tax paid by the trustee on income they have received from the trust.

Discretionary/accumulation trusts

The first £1,000 of income received by a discretionary or accumulation trust is taxed to the trustee at 20 per cent for rent, trading and savings and 10 per cent for UK dividends. Any amounts above £1,000 are taxed to the trustee at 42.5 per cent for dividend type income (such as income from stocks and shares) and 50 per cent for all other income (rent, business income and savings).

Trustees are also generally liable to pay tax at 28 per cent on any capital gains made by the trust which exceed £5,300 (for the 2011-12 income year).

Where a beneficiary receives a distribution from a discretionary trust the payment carries a tax credit of 50 per cent. The beneficiary will then be able to claim a refund of some or all of the tax if they are subject to a lower rate of tax.

To ensure that the trustees of discretionary trusts have paid enough tax to cover the amount of the beneficiaries' tax credits, trustees are required to keep a record of all of the discretionary income payments that they make as well as the amount of tax that they have actually paid.

Character retention

A payment to a beneficiary out of income retains its income character, and a payment out of capital retains its capital character.

NEW ZEALAND

Trust structure

New Zealand has three types of trusts:

- Complying trusts — one which has been taxed in New Zealand on all its income since the date it began.
- Non-complying trusts — any trust that is not a complying or foreign trust. Generally a trust is a non-complying trust if the only trustee income is non-resident withholding income or the trustees earn foreign source income excluded from the meaning of assessable income.
- Foreign trusts — are defined by reference to the time of a distribution. A foreign trust is a trust of which no settlor has been a resident of New Zealand from the later of 17 December 1987 or the date the trust was first settled, until the date of the distribution in question.

What are trusts primarily used for?

Trusts are used for a variety of purposes including investment, asset protection and succession planning.

Taxable income

Broadly, the taxable income of a trust for an income year is the total of the 'trustee' and 'beneficiary income' as well as any 'taxable distributions'.

Attribution method

Trustees and beneficiaries are subject to tax on three different amounts. These include:

- 'Beneficiary income' which is the income derived by trustee that vests absolutely in interest in the beneficiary in an income year (that is, beneficiary has immediate fixed right of present or future income) or is paid to a beneficiary during an income year or 6 months after an income year;
- 'Trustee income' is an amount of income derived by a trustee of a trust to the extent that it is not beneficiary income (that is, income to which no beneficiary is presently entitled) and is not paid to a beneficiary during an income year or 6 months after an income year; and
- 'Taxable distributions' are any distribution to a beneficiary from a foreign or non-complying trust not being 'beneficiary income' or distributions which compromise corpus of the trust.

A trustee is generally liable to pay tax on any:

- 'trustee income' at 33 per cent; and

- ‘beneficiary income’ at beneficiaries’ marginal tax rates

Beneficiaries are also liable to pay tax on their share of any ‘beneficiary income’ at their marginal tax rates. However, in order to avoid double taxation beneficiaries are entitled to a tax credit for any tax that the trustee has already paid on this income.

Beneficiaries are also subject to tax on ‘taxable distributions’. If a ‘taxable distribution’ is received from a foreign trust it is taxed at the relevant beneficiary’s marginal tax rates, alternatively if the trust is a non-complying trust it is taxed at 45 per cent.

Character Retention

‘Beneficiary income’ that is distributed to beneficiaries retains the same character as when it was derived by the trustee — but ‘taxable distributions’ are considered to be a separate category and do not retain the same character as they had in the hands of the trustee.

IRELAND

Trust structure

The two main types of trusts in Ireland are fixed and discretionary trusts.

Fixed trusts (also known as interest in possession trusts) — the trust document sets out who the beneficiaries are and how the income and capital of the trust is to be dealt with. Trustees do not hold any discretionary power.

Discretionary trusts — the potential beneficiaries are named in the trust document but do not have any right to the assets or income of the trust.

What are trusts primarily used for?

Fixed trusts may be used to enable property to be held for persons who cannot hold it themselves (that is, a minor child or incapacitated person), or to allow a life or limited interest to be given to a beneficiary.

Discretionary trusts can be used and are often set up under a will. The settlor normally provides a ‘letter of wishes’ indicating how they would like the property to be distributed which may influence the trustees.

Taxable income

Trustees are generally taxable on income and capital gains earned from all sources.

Attribution method

Trustees are generally assessed on income generated by a trust at the standard rate of 20 per cent. However, where income is accumulated in trust and is not distributed within 18 months from the

end of the year of assessment, an additional 20 per cent rate of tax will apply, effectively taxing these amounts at 40 per cent.

Trustees are also liable to pay capital gains tax at 25 per cent on any capital gains made by the trust.

Where a beneficiary receives a distribution from a trust they are liable to tax on this income at their marginal tax rates but are entitled to a credit for the tax already paid by the trustee.

Beneficiaries may also be liable to pay capital acquisitions tax at 25 per cent in circumstances where they receive a distribution of a capital from a trust. If the trustee has already been subject to capital gains tax on this amount a credit is available for the payment of this tax so long as certain conditions are met by the beneficiary.

In addition to the standard application of income tax, certain discretionary trusts may also be liable to pay 'discretionary trust tax'. Broadly, discretionary trust tax applies to trusts where the person who established the discretionary trust has died and beneficiaries are over the age of 21.

Where this condition is satisfied a one off 6 per cent 'charge' will apply to the trust with an ongoing annual 'charge' of one per cent in years where there is no person that has an interest in possession in the trust capable of lasting five or more years.

Character Retention

Income going into a trust loses its character and is regarded as coming from a new source when it is distributed.

South Africa

Trust structure

Aside from the general definition of trust, there are also two types of 'special trust' that are subject to different tax rules:

- A trust created solely for the benefit of person who suffers from a defined mental incapacity, or serious physical disability; and
- A trust created under a will solely for beneficiaries who are relatives of the testator who are alive at the date of death, as long as the youngest beneficiary is under the age of 21.

What are trusts primarily used for?

Trusts are used for a variety of purposes including estate planning, protection against creditors, and collective investment schemes such as mutual funds or unit trusts.

Taxable income

A trust is treated as an individual for tax purposes.

Attribution method

In general, the beneficiaries of a trust are subject to tax on income and taxable capital gains distributed to them by the trustee. They are also liable to tax on income of the trust to which they are presently entitled (if they are a 'vested beneficiary').

The trustee is taxable on undistributed income as well as any local capital gains of a non-resident beneficiary.

For undistributed income, trustees are taxed at the highest individual tax rate (40 per cent in 2009). Trustees for special trusts are taxed at progressive individual tax rates, which range between 18 per cent and 40 per cent.

Broadly, trustees are not entitled to rebates available to individuals but are entitled to a rebate for foreign taxes on income.

Trust losses cannot be distributed but can be carried forward and offset against future income of the trust.

Character Retention

The income of a trust retains its nature in the hands of beneficiaries.