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## **Modernising the Taxation of Trust Income (Comments on Discussion Paper)**

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# Modernising the Taxation of Trust Income

## (Comments on Discussion Paper)

By

Ian Gray Solicitor

### 1. Introduction

A Trust is a legal mechanism by which Capital and Income are aggregated and segregated for the ultimate commercial benefit of some or all of the Beneficiaries.

It is a relationship, not a separate taxable entity.

Theoretically, it should not be difficult to understand and segregate the commercial and tax implications with respect to the activities of the Trust insofar as they apply to each of the individual Beneficiaries.

Similar implications must occur in the case of other economic aggregation or collective vehicles such as Partnerships.

In both cases, the economic and legal entity must receive Capital and Income (even though it might not be subject to income tax in its own right) and distribute the Capital and Income to the Beneficiaries or Partners (who might be subject to income tax in their own right, unless they too are Trusts or Partnerships).

The aim is to make a good faith attempt to get to the underlying truth with respect to the activities of the collective entity.

Past attempts by the ATO to administer the Legislation have been complicated by an underlying suspicion that Trusts are primarily a vehicle for tax evasion.

Unfortunately, these attempts can frustrate the proper use of legitimate collective economic vehicles until a suitable case is available to take to the High Court to establish that the ATO view has been erroneous.

It is arguable that the **Bamford Case** is a case that showed just how erroneous the ATO can be.

It is submitted that these errors can be avoided by Legislation and Administrative Practice if Trusts (and Partnerships) are viewed as aggregation or collective vehicles that can be assembled and dis-assembled rationally.

### 2. Previous Submission with respect to “Improving the Taxation of Trust Income”

At the end of this document is a copy of my submission with respect to the “Improving the Taxation of Trust Income” Discussion Paper.

My submissions are still relevant to the issues raised in this Discussion Paper.

### 3. Use of the Term “Distributable Income” (Question 7)

In my previous submission, I suggested that the term “distributable income” in section 97 can be dispensed altogether.

This term appears only in the prefatory wording of section 97.

I submit that the primary role of the prefatory wording is to differentiate between:

- the situations where section 97 applies (i.e., where the **Beneficiary** is assessable); and
- the situations where section 99 (and any other sections that make the **Trustee** liable) apply.

Once it is accepted that the Beneficiary is liable (as opposed to the Trustee), then the substantive operative provisions of section 97 would apply.

#### Suggested Drafting

It is submitted that the substantive performative provisions in the remainder of section 97 should apply if a Beneficiary is “presently entitled to any of the **assessable or exempt income** of the Trust Estate”.

This drafting:

- avoids the need to use the term “distributable income”; and
- uses existing terms that apply to other taxable entities.

This suggestion addresses Question 7 of the Questions for Consultation.

### 4. “Flow Through Approach”

The Tax Legislation recognises the fact that a Trust is a relationship (not an entity) by effectively providing that the Trust itself is not a separate taxable entity.

However, each of the parties to the Trust (i.e., the Trustee and the Beneficiaries) could have a tax liability in different circumstances.

In general:

- (a) the Beneficiaries are liable to tax with respect to any Income of the Trust to which they are “presently entitled” (section 97 of the 1936 Act); and
- (b) the Trustee is liable to tax with respect to any Income of the Trust to which no Beneficiary is “presently entitled” (section 99 of the 1936 Act).

It is true that the Trustee of the Trust will receive Income and Capital.

However, it will do so in a fiduciary or representative capacity on behalf of the Beneficiaries who are entitled to their share of the Income or Capital.

If neither the Trust itself nor the Trustee is assessable, then it is appropriate to treat the Income or Capital as derived directly from the ultimate source without the intervention of the Trust or the Trustee.

Therefore, it is intellectually appropriate to treat the Income or Capital as having flowed through and retained its character.

### **Sections 6B(2A) and (3) of the ITAA 1936**

Sections 6B of the 1936 Act already supports the Flow Through Approach in relation to dividend, passive and interest income.

Sections 6B(2A) and (3) supports the Flow Through Approach in relation to the (presumably geographical) source of income.

Below is the type of drafting already used in the 1936 Act:

***“(2A) For the purposes of this Act, an amount of income derived by a person shall be deemed to be income derived from a particular source:***

***(a) except where paragraph (b) applies:***

***(i) if the person derived the amount of income by reason of being beneficially entitled to an amount that is derived from that source; or***

***(ii) if the person derived the amount of income as a beneficiary in a trust estate and the amount of income can be attributed, directly or indirectly, to income derived from that source or to an amount that is deemed, by any other application or applications of this subsection, to be an amount that is income derived from that source; or***

***(b) if the income so derived is, by virtue of subsection (1), (1A) or (2), attributable to a dividend, passive income or interest income derived from that source.***

***(3) Where a beneficiary in a trust estate is presently entitled to income of the trust estate, that income shall, for the purposes of this section, be deemed to be an amount of income derived by the person.”***

## **5. “Follow the Money Approach” (Principle 1)**

Principle 1 in the Discussion Paper provides as follows:

***“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.”***

The term “Follow the Money Approach” is an attractive catchphrase.

However, its catchiness disguises a number of implications of the Tax System that apply equally to all taxpayers.

If the term “distributable income” is dispensed with, then there would be little substantive differentiation between Beneficiaries of Trusts and other taxpayers.

The aim would be to get to the underlying truth of the income or capital gain derived by each Beneficiary in the same way that this is the task that confronts any other taxpayer.

## **Expenses**

In any business activity, there will be gross income and expenses.

Where one individual is the taxpayer, the individual will be beneficially entitled to the income and beneficially responsible for the expenses.

The result of this normal accounting process will be that the individual will be beneficially entitled to the net income.

If the gross expenses are equal to or greater than the gross income, there will be no accounting profit.

However, not every expense is deductible, thus it is possible that the individual might have assessable income, even though they don't obtain any net accounting income.

In addition, there are provisions in the Tax Legislation (such as the Market Value Substitution Rules in relation to Capital Gains), where a taxpayer may be **deemed** to have derived income or a Capital Gain, even though they did not actually receive that income or deemed consideration.

Both situations can result in an individual taxpayer having a tax liability, even though they did not **actually** “receive the money”.

The same situations can apply in the case of a Trust or a Partnership.

The use of the catchphrase “Follow the Money Approach” should not be permitted to distract attention from the reality that Beneficiaries of Trusts are treated in exactly the same way as individual taxpayers in these circumstances.

It is also submitted that the Beneficiaries should be viewed as beneficially responsible for the expenses of the Trust, in the same way as they would be in the case of an individual.

The Trustee pays Trust Expenses in a fiduciary or representative capacity on behalf of the Beneficiaries who are entitled to their share of the Income or Capital.

Thus, the equitable relationship should apply to both income (including gross income) and expenses.

## **6. Streaming**

Streaming is a product of the Trust Deed.

If a Trustee has the legal or contractual power to stream Income or Capital to different Beneficiaries in different proportions, then streaming is a legitimate product of the legal or contractual freedom of the parties.

The Tax System should recognise and respect this freedom.

If any particular exercise of this right results in a transaction that offends some other public policy principle, then that particular type of exercise can be attacked by specific and narrowly defined Legislation.

For example, the streaming of Trust Income to Minors is already taxed at a different rate that is designed to minimise this practice.

## **7. Differential Treatment of Different Types of Trust**

The Discussion Paper seeks to preserve any existing differential treatment of different types of Trust.

This in its own right makes it difficult to develop a conceptually robust and consistent approach to the taxation of Trust Income.

This is not to say that there are no grounds for the carving out of some types of Trust from the body of the Legislation.

However, it preempts the outcome of this consultation process.

## **8. Trust Losses**

Similarly, Principle 5 seeks to preserve the existing treatment of Trust Losses:

***“Trust losses should generally be trapped in trusts subject to limited special rules for their use.”***

This in its own right makes it difficult to develop a conceptually robust and consistent approach to the taxation of Trust Income.

This is not to say that there are no grounds for adopting this view.

However, it defies the logic of the “Flow Through Approach” and preempts the outcome of this consultation process.

## **9. Interaction with Section 106-50 (Absolute Entitlement Trusts)**

I reiterate my submissions with respect to section 106-50 in Part 9 of the attached Submission.

# Improving the Taxation of Trust Income

## (Comments on Discussion Paper)

By

Ian Gray Solicitor

### 1. Introduction

Many of the problems discussed in **Bamford** derive from the prefatory words to section 97(1) of the ITAA 1936:

*“where a beneficiary of a Trust Estate who is not under any legal disability is presently entitled to a share of the income of the Trust Estate...”*

Before **Bamford**, the ATO interpreted these words to act as a condition that had to be satisfied, in order for the substantive provisions to operate.

As a result, the wording became a gateway to the further operation of the section.

Unfortunately, the wording was ambiguous and introduced a concept of “a share of the income of the Trust Estate” that was not used elsewhere in the Tax Legislation.

As a result, it created considerable uncertainty about how the section worked and in what circumstances it applied.

This uncertainty was further exacerbated by ATO arguments that “income” referred only to “ordinary income” and did not embrace “statutory income” (e.g., capital gains).

In my opinion, the prefatory wording could be given a sensible meaning in the context of the 1997 Act, if it was recognised that “income of the Trust Estate” meant both:

- Assessable income (which includes ordinary and statutory income under section 6(1) of the 1997 Act); and
- Exempt income (which is not assessable income under section 6(3) of the 1997 Act).

In other words, it meant any type of income.

### 2. Primary Role of Prefatory Wording of Section 97(1)

I submit that the primary role of the prefatory wording is to differentiate between:

- the situations where section 97 applies (i.e., where the Beneficiary is assessable); and

- the situations where section 99 (and any other sections that make the Trustee liable) apply.

Once it is accepted that the Beneficiary is liable (as opposed to the Trustee), then the substantive operative provisions would apply.

### 3. Substantive Operative Provisions

The substantive operative provisions are actually quite common sense.

They basically establish a logical and practical system for dealing with the following subject matter “proportionately”:

- “assessable income”;
- “exempt income”; and
- “non-assessable non-exempt income”.

The method of apportionment takes into account the period of residence of the Beneficiary and the source of the income.

When these references are omitted, the relevant proportion is “the individual interest of the Beneficiary”.

It is submitted that this interest should reflect the actual amount distributed or deemed to be distributed to the Beneficiary.

### 4. Proposed Amendment of Prefatory Wording

It is submitted that the intended role of the prefatory wording could be performed by adopting words that are neutral about the quantity or quantification of the amount or share or interest of the individual Beneficiary, e.g.,:

***“where a beneficiary of a Trust Estate who is not under any legal disability is presently entitled to **any of the assessable or exempt income of the Trust Estate**”.***

#### 4.1 “Assessable Income”

Please note that I have referred to “assessable income”, because under section 6(1) of the 1997 Act, it incorporates both:

- “Ordinary income”; and
- “Statutory income”.

#### 4.2 “Exempt Income”

I have included “exempt income”, because under section 6(3) of the 1997 Act it does not form part of “assessable income”.



The purpose of this distinction is to establish that, if the only income of the Trust Estate is exempt income, the operative provisions will still apply.

In particular, section 97(1)(b) would extend the exemption to the Beneficiary, even though there was no other assessable income (i.e., even though there was no other ordinary or statutory income).

Currently, if the only income of the Trust Estate was exempt income, there is an argument that:

- section 97 does not apply (because the terms of the prefatory wording have not been satisfied); and
- section 97(1)(b) does not pass the exemption on to the Beneficiary.

#### **4.3 Operative Provisions**

Once this prefatory wording is satisfied, paragraphs (a), (b) and (c) will apply to the Beneficiary.

This makes it clear that the amount of the share or interest is irrelevant to the operation of the subsequent paragraphs.

This simple amendment removes the distinction between:

- “distributable income”; and
- “assessable income” or “taxable income”.

This distinction is and always has been a red herring.

The Tax Legislation should be concerned with “assessable income” and “taxable income” in the same manner as it is with other entities.

## **5. Ordinary and Statutory Income**

I do not accept that there ever was a legitimate argument that section 97 applied only to ordinary income, and not to statutory income.

Section 102-5 includes the Trust’s net capital gain in the assessable income of the Trust Estate.

Section 115-215(2)(b)(i) of the 1997 Act envisages that the Beneficiary’s assessable income might include an amount (“a trust amount”) attributable to a capital gain of the Trust Estate as a result of the operation of section 97(1)(a).

Thus, it is submitted that the correct interpretation of section 97 has always been that it was the vehicle for both ordinary and statutory income of the Trust Estate to get into the assessable income of the Beneficiary.

However, to the extent that there is perceived to be any ambiguity or uncertainty, it should also be made clear that the section applies equally to ordinary and statutory income.

## 6. Secondary Role of Prefatory Wording of Section 97(1)

The secondary role of the prefatory wording is the role it plays or could play in the quantification of the amount or share or interest of the individual Beneficiary.

This role is potentially in conflict with the wording of the substantive section.

It is submitted that, for the purposes of clarity:

- The prefatory wording should have no role in the determination of the **amount** of the assessable income of a Beneficiary; and
- this role should be performed solely by the substantive provision or a separate provision.

## 7. Quantification

A Trust is a legal mechanism by which capital and income are aggregated and segregated for the ultimate commercial benefit of some or all of the Beneficiaries.

### 7.1 Fixed Trusts

Where the Trust is a Fixed Trust, the interest of each Beneficiary is fixed and apportioned by the Trust Deed.

The ITAA should respect this apportionment.

Just because a Fixed Trust is fixed doesn't mean that the one apportionment is applicable to all forms of income.

The Trust Deed may provide for different apportionments for different types of asset or income.

For example, the Trust deed might provide that the proceeds of sale of one asset might be apportioned differently to the proceeds of sale of another asset.

This might potentially be described as "streaming".

However, if that is what the Trust Deed permits, so be it.

Again, the ITAA should respect an apportionment in accordance with the Trust Deed.

### 7.2 Discretionary Trusts

The purpose of a Discretionary Trust is to give to the Trustee a discretion as to what income is distributed to which Beneficiaries.

If the public policy of the ITAA respects this discretion, then it should respect the apportionment by the Trustee acting in accordance with the Trust Deed.

## **8. Exempt Income of a Beneficiary**

Section 97(1)(b) extends an exemption of the Trust Estate to the individual Beneficiary.

However, some income of a Trust might be exempt in the hands of a particular Beneficiary (even though it might not have been exempt in the hands of the Trustee or the Trust Estate), because of some characteristic peculiar to that Beneficiary.

For example, section 118-300 grants an exemption with respect to Insurance Proceeds on the basis of the original beneficial ownership of the Policy.

Where the Insurance Proceeds are exempt in the hands of the particular Beneficiary, it is submitted that, for the purposes of clarity, the Tax Legislation should extend the exemption to the Trustee itself.

Thus:

- if the Trustee or the Trust Estate is exempt, the Beneficiary should be exempt; and
- if the Beneficiary is exempt, the Trustee or the Trust Estate should be exempt.

## **9. Interaction with Section 106-50 (Absolute Entitlement Trusts)**

There is no mention of section 106-50 in the Discussion Paper.

My concern is that there be no amendment in this context that incidentally affects the operation of section 106-50.

The operation of this section might be the subject matter of the general review of the taxation of trusts.

If so, I will make submissions at the time.

However, at this stage, it is sufficient to say that, in circumstances where section 106-50 applies, the capital gain is deemed not to be included in the assessable income of the Trust Estate for the purposes of section 102-5 in the first instance.

Instead, it leapfrogs the Trust Estate and is included directly in the assessable income of the Beneficiary.

Thus, statutory income of this nature gets into the assessable income of the Beneficiary otherwise than as a result of sections 102-5 and 97.

There is currently a debate as to whether section 106-50 can apply where there are multiple Beneficiaries.

It is submitted that this debate is largely a red herring.

If section 106-50 is inapplicable, then sections 102-5 and 97 would apply to each Beneficiary in the normal manner.

The result would be identical with one exception.

If there was a tax loss:

- it would be available to the single Absolutely Entitled Beneficiary, if section 106-50 applied; and
- it would be trapped in the Trust Estate and would not be available to any of the multiple Beneficiaries, if section 106-50 did not apply.

Please note that the author does not agree with the ATO interpretation of section 106-50 with respect to multiple Beneficiaries.

However, the purpose of the above comments is to suggest that, if section 97 is correctly applied, the section 106-50 issue mightn't be as big an issue as it is made out to be.

In other words, **Bamford** has pointed to a solution to the section 106-50 debate as well.