Taxing trust income – options for reform

Policy options paper
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Consultation Process

Request for feedback and comments

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

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

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

Closing date for submissions: 5 December 2012

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FOREWORD

I am pleased to release this policy options paper as the next stage in the Gillard Government's reform of the trust tax provisions.

The need for reform was highlighted by the *Australia's Future Tax System Review*, which recommended that the trust rules be updated and rewritten to reduce complexity and uncertainty around their application.

In response to that recommendation, the Government released an initial consultation paper, *Modernising the taxation of trust income — options for reform*, in November 2011 which outlined three possible models for taxing trust income. More than 30 written submissions were received and stakeholder consultation forums were well attended. The consultation highlighted, in particular, a desire for more information about two of the proposed models — the 'trustee assessment and deduction' model, and the 'proportionate within class' model.

This paper responds to that feedback and further articulates these models, which have been re-badged as the 'economic benefits model' and the 'proportionate assessment model' to better reflect their objectives.

These reform options have been developed drawing on the expertise of the private sector and in consultation with the Australian Taxation Office.

The Government welcomes further input on these policy options and will consider the views of all stakeholders before taking any decisions on how to modernise the taxation of trust income.

As the Government takes these reforms forward, I would like to acknowledge the cooperative spirit in which stakeholders have engaged in the process so far. I look forward to continuing this constructive dialogue as the Government finalises its policy approach in the coming months.

The Hon David Bradbury MP
Assistant Treasurer

Abbreviations

ATO	Australian Taxation Office
Board	Board of Taxation
CGT	capital gains tax
GST	goods and services tax
Commissioner	Commissioner of Taxation
Income tax law	the ITAA 1936, the ITAA 1997 and the TAA 1953
ITAA	Income Tax Assessment Acts
ITAA 1936	*Income Tax Assessment Act 1936*
ITAA 1997	*Income Tax Assessment Act 1997*
MIT	managed investment trust
NANE income	non-assessable non-exempt income
TAA 1953	*Taxation Administration Act 1953*
2011 paper	*Modernising the taxation of trust income — options for reform*, November 2011

1. Introduction

Background

In December 2009, the *Australia's Future Tax System Review* recommended that the rules relating to the taxation of trusts be updated and rewritten to reduce complexity and uncertainty around their application.[1]

The Government announced it would conduct public consultation as a first step to updating and rewriting the trust income tax provisions, drawing on the expertise of the private sector.[2]

The initial consultation paper, *Modernising the taxation of trust income – options for reform* (the 2011 paper), explained that any options for reform would be developed within the broad policy framework currently applying to the taxation of trust income. Specifically, it noted that the taxable income of a trust would continue to be assessed primarily to beneficiaries, with trustees being assessed only to the extent that amounts of taxable income were not otherwise assessed to beneficiaries. The Government has also announced that the reform options would not include taxing trusts like companies[3], which would be a major departure from current law.[4]

The models for taxing trust income discussed in this paper are consistent with this framework and are also consistent with the five policy principles outlined in the 2011 paper. Those principles are:

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.

The models aim to provide tax treatment that is as simple as possible whilst working within the above parameters. However, trusts may be used for complex purposes, and interactions between trust and tax

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1 Australia's Future Tax System Review, *Report to the Treasurer, Part Two, Detailed Analysis, volume 1 of 2* (Recommendation 36), Commonwealth of Australia, Canberra, December 2009.

2 The Hon Bill Shorten MP (then Assistant Treasurer and Minister for Financial Services & Superannuation), *Farmers benefit with changes to trust laws*, Media Release number 25 of 16 December 2010.

3 With the exception of those trusts that are already taxed like companies, such as corporate unit trusts and public trading trusts.

4 The Hon Bill Shorten MP (then Assistant Treasurer and Minister for Financial Services & Superannuation), *Farmers benefit with changes to trust laws*, Media Release number 25 of 16 December 2010.

law present challenges for reforms which aim to reduce complexity and uncertainty. The development of both the ‘economic benefits model’ (EBM) and the ‘proportionate assessment model’ (PAM) therefore represent an effort to effectively balance the competing policy considerations, and achieve appropriate tax outcomes for users of trusts.

The EBM uses tax concepts to determine how different amounts should be dealt with for tax purposes. This contrasts with the PAM, which uses general concepts of profit to determine tax outcomes. Both models presuppose compliance with the trust deed and trust law more generally, but move away from relying on the deed’s labelling of amounts as income or capital to determine tax outcomes.

The models are options for reform that the Government is considering and the Government welcomes stakeholder views on them.

Structure of the paper

There are a number of features that will apply to the new arrangements for taxing trust income (Chapter 2), whichever model is eventually progressed. These features are described before the models so that readers can understand the broad framework in which the models would operate. The models articulated in this paper are the:

- EBM (formerly the ‘trustee assessment and deduction’ model (TAD)) in Chapter 3; and

- PAM (formerly the ‘proportionate within class’ model (PWC)) in Chapter 4.

An example of the application of both models to a discretionary trust is provided, as well as a comparison with the application of the current law (Appendix A). Diagrammatic representations of both models are also provided to assist the reader’s understanding (Appendix B).

In addition, the paper also canvasses two issues that will affect the scope of new arrangements for taxing trust income (Chapter 5). These are the treatment of tax preferred amounts and the possible exclusion of bare trusts from the new arrangements.

Some questions are provided throughout the paper (and listed at Appendix C) to focus the reader’s attention on specific policy issues, but submissions are encouraged on any aspect of the core features, scope, or models.

Comparison of current law and new models

CURRENT LAW	EBM	PAM
1. Basis for assessment		
Beneficiaries are assessed on a share of the trust's net income, based on their present entitlement to a share of the income of the trust estate. Trustees are assessed on net income that is not assessed to beneficiaries.	Beneficiaries are assessed on amounts distributed or allocated to them that represent amounts of the trust's taxable income. Trustees are assessed on amounts representing taxable income that are not distributed or allocated to beneficiaries.	Beneficiaries are assessed on a share of the trust's taxable income based on their present entitlement to a share of the trust profit or class amounts. Trustees are assessed on taxable income that is not assessed to beneficiaries.
2. Character retention and streaming		
Capital gains and franked distributions can be streamed to beneficiaries. These amounts retain their tax character when assessed to beneficiaries.	Amounts representing the trust's taxable income retain their tax character when distributed or allocated to beneficiaries, except where other parts of the tax law limit character retention. All amounts can be streamed to beneficiaries.	Classes of taxable income assessed to beneficiaries retain their tax character, except where other parts of the tax law limit character retention. All amounts can be streamed to beneficiaries.
3. Time for determining entitlements		
Trustees must determine beneficiary entitlements by 30 June, other than entitlements to capital gains, which may be determined up to 31 August.	Trustees must declare distributions and allocations to beneficiaries by 31 August.[5]	Trustees must determine beneficiary entitlements by 31 August.

[5] This does not mean amounts must actually be paid by that date.

2. Core features of a new model for taxing trust income

It is proposed that any new model for taxing trust income should have the features described in this Chapter. These features recognise trusts as primarily flow-through vehicles, and attempt to balance the needs of taxpayers for certainty and flexibility within the broad policy parameters that apply to the taxation of trust income.

Providing certainty about character retention and streaming

Character retention

Under a flow-through approach, amounts derived by a trust are generally treated as retaining their character in the hands of beneficiaries. However, the High Court's confirmation of the proportionate method of assessing trust income in the *Bamford* case[6] means that, in the absence of special rules, 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 2011 to ensure that capital gains and franked distributions retain their character for tax purposes.[7]

A new model would extend this certainty beyond capital gains and franked distributions so that all amounts that flow through a trust would retain the character that they had in the hands of the trustee when assessed to the beneficiaries, unless another part of the tax law requires that the amount be treated otherwise.

Streaming

If amounts did not retain their character, then there would be little benefit in streaming —or directing — particular amounts to particular beneficiaries, as there would be no tax advantage to doing so.

The Government's interim amendments clarify that capital gains and franked distributions can be streamed.

A new model would extend this certainty beyond capital gains and franked distributions so that all amounts that flow through a trust can be streamed in a tax effective way to particular beneficiaries in accordance with the trust deed (subject to any other rules in the tax laws). This does not mean that there must be a separate and explicit streaming power in the trust deed; just that the trustee must comply with the trust deed and trust law more generally.

Allocation of deductions

The way deductions are allocated against specific components of assessable income is significant because it can alter beneficiaries' tax liabilities.

[6] *Commissioner of Taxation v Bamford*; *Bamford v Commissioner of Taxation* [2010] HCA 10 at 17.
[7] *Tax Laws Amendment (2011 Measures No.5) Act 2011*.

Currently, the legislation is silent on the manner in which deductions are allocated. However, some submissions on the 2011 paper pointed to the principle of allocating deductions on a 'fair and reasonable basis' established by the High Court in *Ronpibon Tin NL*[8] and generally supported a continuation of this approach.

However, other submissions argued that there should be legislative principles for allocating deductions to provide more certainty for trustees and beneficiaries. Any such requirement could be developed using a principles-based approach rather than the introduction of prescriptive rules.

The following example provides an illustration of deductions being allocated on a fair and reasonable basis:

> The taxable income of Tessa's Trust for an income year is $19,000, which includes the following components of assessable income:
>
> - rent — $5,000;
> - franked distributions — $20,000 ($14,000 plus a gross up of $6,000 for franking credits); and
> - gross capital gain — $8,000.
>
> Tessa's Trust is also entitled to a $14,000 deduction for interest that is directly related to the rental income.
>
> The trustee uses the interest expense to reduce rental income to nil, leaving $9,000 of deductions to reduce the remaining income components on a fair and reasonable basis as follows:
>
> - franked distributions — $9,000 x $14,000/$22,000 = $5,727
> - capital gain — $9,000 x $8,000/$22,000 = $3,273
>
> As a result, the taxable income of Tessa's Trust comprises:
>
> - rent — $0;
> - franked distributions — $14,273 ($14,000 — $5,727, plus the $6,000 gross-up); and
> - capital gain — $4,727 ($8,000 — $3,273).

Question 1

Would introducing a 'fair and reasonable basis' principle into the legislation provide additional certainty for trustees and beneficiaries? What rules would be required to implement this principle?

8 *Ronpibon Tin NL v FCT* (1949) 78 CLR 47.

Capital gains and losses

Beneficiaries would be taxed on capital gains made by the trust to the extent that they are entitled to gross capital gains. That is, before the application of the CGT discount and relevant concessions, but after the application of relevant losses.

Consistent with the tax laws generally, capital losses would only be available to reduce gross capital gains.

Franked distributions

If a trustee makes a beneficiary entitled to, or distributes, a franked distribution (or part thereof) to a beneficiary, the gross up for franking credits will automatically attach to that entitlement or distribution.

Foreign tax paid

If a trustee makes a beneficiary entitled to, or distributes, an amount of foreign sourced income to a beneficiary, the foreign income gross up would automatically attach to that entitlement or distribution.

Extending the time for determining entitlements

Currently, trustees must make beneficiaries entitled to the income of the trust estate by 30 June each income year in order to have a share of the trust's taxable income assessed to those beneficiaries. Where no beneficiary is presently entitled to a part of the income of the trust estate, the trustee is typically taxed at the highest marginal rate (plus the Medicare levy) on that share of the trust's taxable income.

A number of submissions to the 2011 paper called for further time to determine entitlements, with a significant number of these arguing that the time be extended until the due date for lodgement of the trust's tax return or, if a trust lodged before the due date, to the date that the return was lodged.

Recognising that trustees may not have the information available to finalise the trust accounts by 30 June, the time for determining beneficiary entitlements could be extended.

However, the due date for lodgement of trust tax returns is often significantly later than the due date for individual beneficiaries. This becomes particularly problematic where there are chains of trusts.

Therefore, one option would be to extend the time for determining entitlements to 31 August after the end of the relevant income year (where the trust deed permits[9]). This approach is consistent with the Commissioner's former administrative practice for certain trusts that was withdrawn from the 2011-12 income year because it was not supported by law.

Allowing trustees two additional months to determine entitlements provides flexibility, while recognising that beneficiaries have their own tax obligations to comply with, and require information from the trust which will affect those obligations.

9 For example, many trust deeds contain a clause that deems a 'default beneficiary' to be presently entitled to amounts of trust income to which no other beneficiary is presently entitled as at 30 June. The tax law could not override such a clause.

It may be possible to extend the time for determining entitlements further for trusts where beneficiaries have a deferred lodgement date. This may be the case, for example, where all beneficiaries are using a tax agent and therefore have a later due date for their returns. Family trusts[10] may represent such a category of trusts, as beneficiaries may be more likely to use the same tax agent and lodge returns at the time the trust return is lodged.

Question 2

Would it be appropriate to extend the time for determining entitlements beyond 31 August for certain classes of trusts, where it is reasonable to expect that beneficiaries have a lodgement date later than 31 October? What features should such trusts have? Should the trustee be required to obtain the agreement of all beneficiaries? If so, should this be done on and opt-in, or opt-out basis?

Definite amendment periods for trustees

Under current law, the Commissioner has what is effectively an unlimited amendment period where a trustee returns a 'nil' amount of tax payable. This is because the Commissioner does not issue an original assessment in such cases. This means that unless there is a trustee assessment where an amount of tax is payable, the Commissioner could issue a trustee with an original assessment a number of years after the tax affairs of the trust would otherwise have been finalised.

The Commissioner has responded to this issue by adopting an administrative practice that any original assessment for a trustee will only be issued within four years of the later of the due date for lodgement of the trust return or the actual lodgement date of the return. A number of submissions on the 2011 paper called for this practice to be codified.

An option would therefore be that where a trust lodges a return indicating that the trustee is not liable to tax, it would be deemed to be a nil assessment. The Commissioner would have the power to issue an amended assessment up to two or four years from this date.

The trustee tax rate

The 2011 paper asked for suggestions on an appropriate way to address the practical impact of trustee assessments. A number of stakeholders suggested that a reduction in the trustee tax rate would be appropriate. Currently amounts that are not distributed to beneficiaries but are retained in the trust are taxed at the highest marginal rate (plus the Medicare levy).

Stakeholders point to the fact that many trusts use a corporate beneficiary to obtain the benefit of the lower corporate tax rate and believe that reducing the trustee tax rate would not result in a significant loss to revenue. It has also been argued that the reduced reliance on corporate beneficiaries could simplify administration and reduce costs for taxpayers.

However, such a change would need to factor in a range of other considerations.

The current trustee tax rate was introduced as an integrity measure to prevent people from avoiding the progressive nature of individual tax rates, such as by claiming multiple tax-free thresholds. It also

[10] These are trusts that make an election to be treated as family trusts in accordance with section 272-80 in Schedule 2F of the ITAA 1936 and which pass the family control test in section 272-87 in Schedule 2F of the ITAA 1936.

ensures that a taxpayer on the top marginal rate cannot reduce their tax simply by interposing a trust and deferring distributions to a later year.

Therefore, if the trustee tax rate were lowered, integrity rules would be required to ensure that a taxpayer on the top marginal rate could not receive taxable income through a trust without paying 'top up' tax. For example, this could include a mechanism whereby the beneficiaries are taxed at their marginal rate with a credit for tax paid by the trustee and rules akin to the rules in Division 7A of the ITAA 1936 to prevent effective distributions in the form of an advance or loan. The Law Council of Australia noted in its submission on the 2011 paper that such rules would be "extremely complicated", and "practically difficult to implement without effectively taxing trusts in a similar manner to companies".[11]

As noted in chapter 1, the Government has also announced that options for reform would not include taxing trusts like companies. A reduction in the trustee tax rate to a rate closer to the company tax rate would require careful consideration from a regulatory perspective, particularly in light of the different rights and obligations, and advantages and disadvantages associated with different types of business structures.

Reducing the trustee tax rate could have revenue implications, notwithstanding that many trustees may already use a corporate beneficiary. This would need to be considered in the context of the Government's commitment that the reform of the taxation of trust income be broadly revenue neutral.

Therefore, the Government is not inclined to reduce the trustee tax rate unless a clear case can be made that the integrity, regulatory and fiscal issues raised above can be addressed.

Question 3

a) How could the integrity, regulatory and fiscal issues associated with a lower rate be addressed without increasing complexity?

b) Would a 'tax and credit system' (akin to franking credits) increase compliance costs and be too similar to taxing trusts like companies on accumulations?

c) What else could be done to reduce the practical impact of trustee assessments?

Trust resettlements

The Government is aware that decisions taken to change the taxation of trust income may lead users of trusts to alter their trust deeds. Such changes may lead to a resettlement of the trust estate, potentially triggering tax consequences at the federal level such as CGT, and stamp duty liabilities at the state level.

These issues will be considered further as part of the broader question of transitional relief when the final policy is settled by the Government. A number of factors will be relevant to determining whether relief might be appropriate, including, for example, the extent of any changes to the trust income tax provisions, and also whether those changes mandate or merely provide incentives to change trust deeds. In examining these issues, the Government will also consider the High Court's decision in *Clark*, in particular the appropriate parameters for 'continuity of the trust estate'.[12]

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[11] The Taxation Committee of the Business Law Section of the Law Council of Australia, *Submission*, Canberra, 2012, pp 1-2.

[12] *Commissioner of Taxation v David Clark*; *Commissioner of Taxation v Helen Clark* [2011] FCAFC 5; [2011] HCATrans 236

Integrity rules

The applicability and design of any integrity rules will depend on the final model. It may be that the substance of the current integrity rules would continue to have application under the new model. The following rules would apply irrespective of which model is chosen.

Deemed notional amounts giving effect to integrity rules

Trustees would be assessed on notional tax amounts that have been deemed to give effect to integrity rules in the broader income tax law; for example, dividends deemed under Division 7A in respect of loans and capital proceeds deemed under the market value substitution rule. This approach is consistent with the 'follow the money' principle in the sense that there is no money to trace to beneficiaries. Although there is no money to trace to the trustee either, it is the trustee's actions that have led to the amount being assessable, and so by taxing the trustee, prudence is encouraged.

Trust stripping

The trust stripping rules would continue to apply. That is, where a beneficiary entitlement arises in connection with a reimbursement agreement, the beneficiary will be deemed not to be so entitled. A reimbursement agreement is an agreement that provides for the payment of money or other benefits for someone other than the beneficiary.

Notification of entitlements

Currently, trustees are required to pay or notify an exempt entity that it has been made presently entitled to income for that entitlement to be recognised for tax purposes. Trustees must do this within two months of the end of the income year.

An option would be to require trustees to notify all beneficiaries of entitlements in accordance with the relevant time for determining entitlements. Details of the relevant taxable components referable to their trust entitlements, including their tax characteristics, would need to be included.

This change would ensure that all beneficiaries will know if a trust amount needs to be included in their tax return. For trustees that already meet their obligations and provide distribution statements to their beneficiaries, this should not impose any additional compliance burden.

3. Economic benefits model (EBM)

Overview

The EBM further develops the ‘trustee assessment and deduction’ model from the 2011 paper.

Broadly, the EBM would assess beneficiaries on taxable amounts distributed or allocated to them, with the trustee assessed on any remaining taxable income.

The EBM requires a trustee to calculate the trust’s taxable income as if the trust were a resident taxpayer.

The trustee would then apportion tax liabilities for an income year between beneficiaries and the trust by distributing or allocating amounts representing the trust’s taxable income to beneficiaries.

The amounts distributed or allocated to beneficiaries would have the same character and source in the hands of those beneficiaries as the components of the trust’s taxable income that they represent. If the trustee does not specify that an amount distributed or allocated to a beneficiary represents a particular component of taxable income, the amount would be taken to represent a proportionate share of each component of the trust’s taxable income not otherwise distributed or allocated.

The assessment process

1. Calculate the trust’s taxable income as if the trust is a resident taxpayer.

2. Identify the components of the trust’s taxable income.

3. Distribute and allocate amounts representing taxable income.

4. Beneficiaries are assessed on amounts distributed and allocated to them.

5. The trustee is assessed on the remaining taxable income.

Method for distributing and allocating amounts representing taxable income

Concepts of ‘distributing’ and ‘allocating’ amounts to beneficiaries are central to the EBM.

Distributions

The ‘distribution’ concept would include any amount (whether in money or other property) representing the taxable income of the trust which is:

- paid to;

- applied on behalf of;

- credited to; or

- unconditionally set aside for

any beneficiary, in their capacity as beneficiary of the trust.

The trustee would be able to distribute amounts representing taxable income that have accrued to the trust for accounting purposes, but which have not yet been received.

In order for a distribution to be a relevant distribution of an amount representing taxable income, the trustee must have recognised the distributed amount in its accounts in the income year, or alternatively, the amount must have otherwise been received or appropriately come home to the trust in that year.

Question 4

Should trustees be able to fund distributions from other sources if an amount representing taxable income has not been recognised in its accounts, or otherwise been received or come home to the trust (bearing in mind the trustee's ability to allocate amounts as described below)?

Example 1

Kevin's Trust derived taxable income of $53,000. The trustee resolved to distribute $27,000 to Abed, and $26,000 to Vorenus. On July 30, the trustee transferred those amounts into their bank accounts. Therefore, $53,000 of taxable income has been distributed.

Example 2

The taxable income of Adam's trust comprises $5,000 net rental income. Adam intended to distribute the income to Alice, but failed to pay, apply, credit or set aside the amount. It has not been distributed.

Example 3

The only profit derived by Fatima's Trust was a capital gain. The trustee resolved to distribute the gross capital gain to Tim. The trustee notified Tim of this and, with Tim's implied consent, credited a loan account in Tim's name and treated the amount as being loaned back to the trust for use as trust working capital. The trustee has credited the amount to Tim, and so it has been distributed.

Example 4

Niko holds funds on trust for Priya. Niko derives $10,000 interest income which is applied on Priya's behalf when Niko pays Priya's university fees. The $10,000 has been distributed to Priya.

Example 5

Kyril, the trustee of a family trust, resolves to distribute $5,000 net rental income for the income year to Gordon. Under the terms of the trust deed, Kyril must set the income aside in a separate trust for Gordon until he reaches the age of 25. The $5,000 has been distributed to Gordon because it has been applied on his behalf.

Allocations

The 'allocation' concept would deal with some amounts that cannot be distributed because they have not yet been received.

A trustee may allocate an amount representing taxable income that is not yet capable of distribution because the trustee has not yet recognised it in its accounts and it has not otherwise come home to the trust. Such an amount can only be allocated if the trustee expects to recognise it at a later time.

Example 6

> Rod's Family Trust makes a capital gain of $100,000 in the 2014 income year as a result of entering into a contract that settles in the 2015 income year. As such, the trust has not yet recognised the amount in its accounts and so it will not be possible to distribute in the 2014 year an amount representing the capital gain. Instead, it is clear that the trust will receive the amount in the future, and so the trustee allocates the capital gain to Hilary.

Where such amounts are allocated to beneficiaries and not subsequently distributed by the time that the beneficiary lodges its tax return, the trustee would be assessed on behalf of the beneficiary in accordance with the *Income Tax Rate Act 1986*, similar to the current mechanism for taxing those beneficiaries under a legal disability. This would mean that where the beneficiary is a company, tax would be paid at the company rate. Where the beneficiary is an individual, tax would be paid at marginal rates (without the tax free threshold). When the beneficiary subsequently receives the amount, it would be included in their assessable income and they would obtain an offset equal to the amount of tax paid by the trustee. [13]

However, where a beneficiary has an amount allocated to them, they may not ultimately receive a distribution. That is, up until the benefit is actually distributed, the allocation is merely expected, rather than actual. Therefore, if an allocation is not distributed to the beneficiary by the relevant time in the year in which the amount comes home to the trust, the amount would instead be assessed to the trustee at the trustee tax rate (with a credit for tax paid).

In order to allocate an amount to a beneficiary, the trustee would need to record the allocation in writing and notify the beneficiary.

Allocation of deductions

Reflecting the reality of amounts available in the trust after deductions, and consistent with the current law in relation to trust income, distributions and allocations would be based on *net* amounts.

Therefore, the trustee would need to allocate deductions against particular components of assessable income in accordance with the 'fair and reasonable basis' described in Chapter 2 to ascertain the character of relevant components of taxable income assessed to beneficiaries or to the trustee.

The trustee would need to do this regardless of whether they are seeking to stream particular taxable income components to particular beneficiaries, because in the absence of streaming, beneficiaries who receive distributions would be assessed on a proportionate amount of each component of taxable income.

When will a distribution or allocation reduce the remaining taxable income of the trust?

Whether a distribution or allocation reduces the remaining taxable income assessed to the trustee is ascertained by considering the character of amounts in the hands of the trustee before the distribution

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[13] In the case of beneficiaries under a legal disability, the trustee would be assessed on their behalf with an offset for the tax previously paid.

or allocation is made. If the amount does not represent part of the trust's taxable income during the income year, then the trust's taxable income will not be reduced.

Timing

In order for a trustee to reduce its remaining taxable income, distributions and allocations must be declared by 31 August (or a later date if applicable for that trust – see page 12). Distributions must be made good by the date of the trust's tax return or, in the case of allocations made in earlier years, by the date of the trust's tax return in the year the amount comes home to the trust.[14]

Capital gains

A trust's taxable income will only be reduced in respect of a distributed net capital gain to the extent that the gross capital gain has been distributed, less any capital losses and any deductible expenses that have been applied against the net capital gain.

Distributions in prior years of amounts that represent current year capital gains will also count as relevant distributions of current year capital gains, reducing the trust's taxable income assessed to the trustee in the current year, and also being assessable in the current year to the beneficiary in receipt of that prior year distribution. This would include, for example, distributions made out of asset realisation reserves in a prior year, in respect of an asset realised in the current year for a capital gain.

Example 7

> Bhawani's Family Trust made a gross capital gain of $1,000 on the disposal of one of its assets. The asset had been held for longer than 12 months and was eligible for the 50 per cent CGT discount.
>
> The trustee distributes $1,000 representing the gross capital gain to Octavia, an individual beneficiary. If Octavia has no other capital gains or losses, she will be assessed on a net capital gain of $500.
>
> If the trustee had only distributed $500 representing the net capital gain, then Octavia would be taken to have only been distributed half of the gain. Octavia would therefore be assessed on a net capital gain of $250.

Distributions not representing amounts of taxable income

If the trustee distributes an amount which was related to a previous year, the trustee would not be allowed to reduce its share of the trust's taxable income because of that distribution unless the amount relates to the trust's current year taxable income (for example, distributions in a prior year out of an asset revaluation reserve that relate to current year capital gains).

Exempt income and NANE income

A trustee can distribute an amount representing exempt income or NANE income in the same way that they can distribute amounts representing taxable income. However, these distributions would not reduce the trust's taxable income. Such distributions would instead reduce amounts of exempt income or NANE income.

[14] This does not mean that amounts need to be paid out, but rather that the definition of distribution must be satisfied.

Example 8

Imogen's Trust receives a demerger dividend of $5,000, which is NANE income. The trustee distributes the dividend to Ani. The trust's remaining taxable income is not reduced as a result of the distribution. Ani is taken to have NANE of $5,000.

Beneficiaries assessable on amounts distributed or allocated to them

The beneficiaries of a trust would be assessed on the amounts distributed or allocated to them to the extent that the trustee has been able to reduce the trust's remaining taxable income.

As currently occurs, the trustee would be assessed primarily as a collection mechanism in respect of amounts otherwise assessed to certain beneficiaries, such as non-residents and minors.

Character retention and streaming

Amounts distributed or allocated by a trustee to beneficiaries would retain their character in the hands of the beneficiaries provided that they are distributed or allocated within the timeframes for declaring and making distributions and allocations.

As discussed above, this requires the trustee to first identify the net components of its taxable income. The trustee may then distribute or allocate amounts representing particular components of the trust's taxable income to particular beneficiaries.

Example 9

The taxable income of Adam's Trust comprises the following components:

- Rental income (less apportioned deductions) — $10,000
- Foreign interest income (less apportioned deductions) — $60,000 + $6,000 foreign tax offset
- Franked dividend income (less apportioned deductions) — $7,000 + $3,000 franking credit

The trustee distributes $7,000 representing the franked dividend income to Lucy; the $3,000 representing the gross up for franking credits attaches to that distribution. The trustee distributes $60,000 representing the foreign interest income to Jeremy; the $6,000 gross up referable to the amount sheltered by the foreign tax paid attaches to that distribution. Finally, the trustee distributes $5,000 of rental income to Katherine, and $5,000 to Suzanna.

For tax purposes:

- Lucy will be treated as having derived a franked distribution;
- Jeremy will be treated as having derived net foreign interest income; and
- Katherine and Suzanna will be treated as having derived ordinary income.

Alternatively, the trustee may distribute amounts referable to the taxable income of the trust without specifying that particular beneficiaries are to have income with particular characteristics — in which case, each beneficiary's distribution would be taken to comprise a proportionate share of each of the taxable income components that has not been distributed or allocated.

The trustee must notify each beneficiary to whom a distribution or allocation has been made of the amount to be included in their assessable income and of its tax character.

Treatment of amounts not distributed or allocated

The trustee would be assessed on taxable income that is not distributed or allocated.

This would generally include amounts that were incorrectly excluded from the trustee's calculation of taxable income. This is because, under a self-assessment system, responsibility rests with taxpayers to accurately determine and report their tax obligations. It is important that the trustee's calculation of taxable income is accurate, especially where beneficiaries — other taxpayers — are relying on that calculation in order to meet their own tax obligations.

Example 10

> Andrew's Trust reported taxable income of $100,000, consisting entirely of net business income. The trustee distributed an amount representing all of the taxable income to Harvey.
>
> However, the trustee had omitted $5,000 sales income from the taxable income calculation. The Commissioner subsequently amended the trust's tax return. The trustee is assessable on this amount because it is too late to distribute or allocate it.

Amounts that are subsequently distributed would not be taxable to the beneficiary if they have already been taxed to the trustee. As previously discussed, there is an exception for allocated amounts taxed to the trustee on behalf of a beneficiary — these amounts would be assessed to the relevant beneficiary once distributed to them, with a credit being allowed for the tax already paid by the trustee.

4. Proportionate assessment model (PAM)

Overview

The PAM further develops the proportionate within class model from the 2011 paper.

Broadly, the PAM assesses beneficiaries on a proportionate share of the trust's taxable income equal to their proportionate share of the 'trust profit' of the relevant class.

In this way it seeks to improve the current approach by providing for amounts to be dealt with according to the trust profit or class amounts rather than the 'income of the trust estate'. A class is a category into which parts of the trust profit can be allocated.

Where a trust streams particular types of income to particular beneficiaries, each beneficiary would be taxed only on a share of the taxable income in relation to the class amount(s) to which the beneficiary is entitled.

The assessment process

1. Calculate the trust profit.

2. Determine the different classes of trust profit. At a minimum, trustees would typically need to keep separate classes in respect of their exempt income and NANE income. This ensures that a beneficiary that only receives exempt income or NANE will not be assessed on any part of the trust's taxable income. Other amounts can be placed in a single class, or separated into two or more classes.

3. Allocate the trust profit to classes. That is, calculate the class amounts.

4. Determine the proportions of the class amounts to which beneficiaries are presently entitled.

5. Calculate the taxable income of the trust as if the trust were a resident taxpayer.

6. Allocate the trust's taxable income to the classes maintained by the trustee (if applicable). That is, separate the trust's taxable income into specific assessable amounts net of relevant deductions that accord with the classes maintained for trust purposes.

7. The beneficiaries are assessed on the trust's taxable income based on the proportionate share of the class amounts they are entitled to.

8. The trustee is assessed on the remaining taxable income.

Trust profit and class amounts

The central concept currently used to determine a beneficiary's liability to tax under Division 6 is the 'income of the trust estate', which takes its meaning from trust law and the terms of the particular trust deed. PAM would rely on two core concepts — the trust profit and the class amounts.

The 'trust profit'

The trust profit would be a net concept representing broadly the 'profit' accruing to the trust over the income year. This includes capital profits.

Using a concept that brings in both income and capital amounts is intended to ensure a better match between a beneficiary's entitlements to amounts from a trust and the allocation of the tax liability on the taxable income of the trust than is often achieved under the current law with its focus solely on entitlement to trust income.

The definition of trust profit could take more of a comprehensive accrual approach to take account of some of the difficulties that arise due to timing differences. Specifically, trust profit could be identified as the sum of the amounts derived or expended by the trust over any period of time that make up the calculation of the trust's taxable income for the relevant income year, regardless of when they have been or will be accounted for by the trustee.

However, as some of these amounts may be accounted for by the trustee in a future year, a more comprehensive definition would require the PAM to look to concepts of specific entitlement (encompassing a reasonable expectation of receiving the relevant amount) as well as present entitlement to ensure each class of current year taxable income was appropriately allocated. This would add to the complexity of the model.

On balance, it is proposed to use the simpler approach. It accurately reflects the amount generally available for distribution or accumulation, while also moving away from reliance on the trust deed.

Therefore, the 'trust profit' for an income year would consist of the trust's ordinary income for that year plus gross capital gains, net of expenses, losses or outgoings properly chargeable against such amounts at general law, and less any amounts that are subject to withholding tax.[15] This would be the case, regardless of the treatment of the amounts under the deed. Contributions of capital to the trust would not be taken into account in calculating the trust profit.

Example 11

> Attia's Trust had $250,000 of income from share trading, and Antony, one of the beneficiaries, settled $50,000 on the trust in the income year. The trust deed conferred a power upon the trustee to characterise receipts and outgoings as income or capital. The trustee re-characterises $200,000 of the share trading income as capital. Despite the fact that $200,000 was re-characterised, and total accretions to the trust estate were $300,000, the trust profit is $250,000.

[15] This approach may also be appropriate if a Patch Model was adopted.

Question 5

The intent of the definition of trust profit used for the PAM is to capture all accretions to the trust estate excluding contributions of capital. Does the definition of 'trust profit' achieve that? If not, how can it be improved?

Class amounts

The trustee can break the trust profit up into components referred to here as classes. The total of all the class amounts would always equal the trust profit.

Example 12

> Harry's Trust has a trust profit of $90,700, comprising $90,000 net trading income and a $700 franked distribution. The trustee chooses to maintain two classes — 'active business income' (class one) and 'passive investment income' (class two).
>
> The trustee allocates its $90,000 trading income to class one and $700 dividend income to class two.

The trust profit can only be allocated into classes that correspond with the actual legal nature of the amounts allocated, regardless of any re-characterisation by the trustee. For example, an amount of rent could not be made to attract the tax treatment applicable to capital gains simply by allocating the amount to a class of income designated as capital gains. This would not mean that there must be a separate and explicit power to create and record classes of income in the trust deed; just that the trustee must comply with the trust deed and trust law more generally.

One issue that arises is whether the trustee should be able to change classes from year to year. Allowing this would increase flexibility and potentially reduce compliance costs, but could also have unintended consequences that would need to be considered.

Question 6

Should the trustee be able to change the classes from year to year? What limits, if any, could be put in place to prevent unintended consequences?

Beneficiary entitlements to the trust profit or class amounts

As currently occurs, present entitlement would be used as the basis for attributing the trust profit or class amounts to beneficiaries.

Character retention and streaming

An amount with specific tax characteristics cannot be streamed unless there is a corresponding class provided for, or allowed by, the trust deed. For example, a trustee cannot stream an amount of dividends for tax purposes unless the trust has derived dividends during the income year and these dividends have been allocated to a class in a manner that is not prohibited by the trust deed.

Therefore, the trustee would need to identify the classes that would be maintained for trust purposes, and allocate the trust profit to those classes if it wishes to stream relevant amounts to particular beneficiaries. The trustee would in turn need to calculate the taxable income of the trust and allocate the taxable income into assessable amounts that accord with the classes that it has identified.

Deductions must be allocated against each component of assessable income in accordance with the 'fair and reasonable basis' described in Chapter 2.

When apportioning expenses to determine class amounts, losses and outgoings should be allocated in a way that is consistent with the way deductions would be apportioned for tax purposes.

Example 13

> Assume the same facts as in example 12.
>
> The trustee allocates $90,000 trading income to class one and the $700 franked distribution income to class two.
>
> One of the expenses incurred by the trustee on behalf of the trust was $1,100 of accounting fees. In relation to these fees, the trustee's accountant advised that she spent 90 per cent of her time maintaining the trading records and 10 per cent maintaining the dividend and share records. The trustee therefore allocates $990 accounting fees to class one and $110 to class two.

Method for allocating tax amounts

The tax liabilities of the trustees and beneficiaries of the trust are determined in accordance with reference to the beneficiaries' present entitlement to shares of relevant class amounts.

Presently entitled beneficiaries would be assessed on either:

- a share of taxable income proportionate to their share of the trust profit; or
- a share of a component (or components) of taxable income proportionate to their share of corresponding class amounts.

Therefore, if a beneficiary is presently entitled to 30 per cent of the trust profit, the beneficiary would be assessed on 30 per cent of each component of the taxable income. Alternatively, if a beneficiary is presently entitled to 40 per cent of a particular class or classes, the beneficiary would be assessed on 40 per cent of the corresponding components of taxable income.

Example 14

> Arthur's Family Trust maintains two classes of income being 'active business' (class one) and 'passive investment' (class two). On behalf of the trust, Arthur earned dividend and interest income which he allocated to class two.
>
> Arthur made Nancy presently entitled to the class one amount.
>
> Arthur then made David and Hilary presently entitled to the class two amount in equal proportions. David and Hilary will therefore be assessed on 50 per cent of the taxable income of class two, being an equal proportionate share of the interest income and the dividend income.

Capital gains

The PAM would assess beneficiaries presently entitled to a class amount that includes any capital gains of the trust on a proportionate share of the trust's net capital gain for the year. In some situations, the net capital gain of a trust may include a taxable capital gain that does not form part of current year trust profits. In these situations, similar to the current law, PAM could include a specific entitlement rule with respect to capital gains that are reasonably expected to form part of trust profits in the future.

Question 7

Should there be a specific entitlement rule to deal with capital gains?

Disproportionate share of taxable income

Depending on how the notion of trust profit is ultimately defined and in particular how closely aligned the notion is with the current definition of adjusted net income (dealing with notional tax amounts), consideration could be given to whether there is a continuing need for a provision that deals with payments to exempt entities (similar to section 100AB of the ITAA 1936).

Treatment of accumulated amounts

The trustee would be assessed on the trust's taxable income for an income year to the extent it is attributable to trust profits to which no beneficiary has been made presently entitled by the relevant time discussed in Chapter 2.

Distribution of accumulated amounts

Amounts that are accumulated in the trust would not be taxable to the beneficiary when subsequently distributed in a later year. If they have not previously been taxed, then it is possible that another provision of the ITAA would make the amount assessable or result in cost base adjustments.

5. Scope of a re-written Division 6

Treatment of amounts not assessable under Division 6

The 2011 discussion paper discussed the interaction of Division 6 with other parts of the income tax laws and, specifically, the treatment of tax preferred amounts. Broadly, a tax preferred amount is any receipt of the trust for trust law purposes that is not included in the trust's taxable income (either in its own right, or as a result of being sheltered by deductions). Generally, Division 6 does not operate to include tax preferred amounts in the assessable income of the beneficiaries of a resident trust.[16] However, other parts of the income tax law may bring tax preferred amounts to tax.[17]

Some stakeholders argued in response to the 2011 paper that trust income and distributions should be taxed under one division exclusively. That is, where Division 6 does not operate to include an amount of income in the income of the beneficiaries of the trust, that amount should not be taxed by other parts of the income tax law. However, provided amounts are not subject to double taxation, it may be unfair for certain amounts to remain untaxed in the hands of beneficiaries if another part of the income tax law would otherwise bring them to tax.

Question 8

Should any new model for taxing trust income be treated as an exclusive code? If so, why? If not, to what extent should trust distributions otherwise be taken into account for tax purposes?

Bare trusts

Background

While Division 6 technically applies to all but a limited range of trusts (for example, those identified by the Federal Court in the *Colonial* case),[18] taxpayers generally ignore so-called bare trusts for tax purposes.

The term 'bare trust' is not statutorily defined for tax purposes and, although the concept is used in trust law and by commentators, the precise characteristics that distinguish bare trusts from other trusts are not settled.

Generally, a bare trust arrangement occurs when a trustee takes legal title to an asset (such as a share) because this allows a more efficient way to maximise returns on that asset or it provides legal and commercial benefits to the beneficial owner of the asset. Control of the asset and the unlimited rights to deal with the asset remain with the beneficial owner.

A majority of submissions made in response to the 2011 paper supported carving out bare trust arrangements from Division 6. Therefore, it is appropriate to consider how a bare trust should be

16 Though note the potentially wide scope of section 99B of the ITAA 1936.
17 For example, sections 104-55 (CGT event E4) and 6-5 of the ITAA 1997.
18 *Colonial First State investment Limited v Federal Commissioner of Taxation* [2011] FCA 16.

defined. Any proposed definition will also need to be considered in the context of the CGT and GST provisions.

Current industry practice

Currently, widespread industry practice is to disregard bare trusts for Division 6 purposes. Tax practitioners treat the beneficiaries of such trusts as holding the trust assets and as being responsible for any tax obligations in respect of them. Trust income is returned by the beneficiaries directly — this means that they also claim losses.

Moreover, pursuant to an administrative practice, the Commissioner has granted trustees an exemption from lodging a tax return on behalf of any transparent trust or secured purchase trust.[19]

Board of Taxation consideration

In its review of the tax arrangements applying to managed investment trusts (MITs), the Board recommended that investor directed portfolio services (IDPS) and similar bare trust type arrangements should generally be excluded from taxation under Division 6.[20]

The Board also recommended that IDPS and similar 'bare trust' type arrangements not qualify for the proposed new tax system for MITs because it considered these arrangements sufficiently different from modern managed funds that they should be subject to different taxation arrangements.

Question 9

Should bare trust type arrangements be excluded from the new model for taxing trust income?

Characteristics of bare trusts

Consistent with the common notion of what a bare trust is, arrangements with the following characteristics could be treated as a bare trust:

- the beneficiary/ies ('beneficiary') holds a clearly definable fixed interest in all of the trust income and capital;
- the beneficiary can direct the trustee on how to deal with trust asset/s in respect of their interest and call for the ownership of those asset/s to be transferred;
- the beneficiary can compel the trustee to provide all information and documents relevant to the beneficiary's income tax obligations;
- the trustee has no active duties of management imposed by the trust instrument; and

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19 Commissioner of Taxation, *ATO Practice Statement Law Administration 2000/2 An exemption for the trustees of some trust estates from the requirement to furnish a tax return on behalf of the trust estate*, Commonwealth of Australia, Canberra, 2000. A transparent trust is a trust in which the beneficiary of the trust estate has an absolute, indefeasible entitlement to the capital and the income of the trust. A secured purchase trust is a trust created solely to facilitate the financing or holding of publicly listed company shares or publicly listed units in a unit trust.

20 Board of Taxation, *Review of the Tax Arrangements Applying to Managed Investment Trusts: A Report to the Assistant Treasurer*, Commonwealth of Australia, Canberra, August 2009. See Recommendation 48 on p 102.

- the trustee's general right at trust law to be relevantly indemnified out of trust assets is ignored in determining whether the trustee has active duties.

Beneficiaries of a trust with a legal disability will prevent the trust from being deemed a bare trust, except for CGT purposes.

In addition, certain types of trusts could be deemed to be bare trusts to provide additional certainty. This could be facilitated by including a regulation making power in the law. This could include those represented by a custodian holding assets pursuant to a requirement in the *Corporations Act 2001*.

Question 10

Are the characteristics of bare trust type arrangements sufficient to describe and possibly define such arrangements?

Income tax consequences

If bare trusts were carved out from the operation of a rewritten Division 6, then these types of arrangements could be ignored or 'looked through' for income tax purposes (including for CGT purposes). Any losses would also be those of the beneficiary and not trapped in the trust.

Trustees and beneficiaries of a trust that demonstrate the above characteristics would be able to:

- disregard a beneficiary's interest in the trust (so that the beneficiary does not also make a gain or loss from a dealing with that interest);
- treat the trustee as though it does not own the assets for tax purposes;
- treat the beneficiary as the owner of the assets (including, for example, treating them as shareholders for the purposes of those provisions that apply to shareholders); and
- treat anything done by or to the trustee as having been done by or to the beneficiary.

In developing a carve-out for bare trusts, consideration would also need to be given to transitional rules for existing trusts to which Division 6 currently applies, but would be excluded from the new model. For example, the beneficiaries of an existing trust that are not currently absolutely entitled to the trust assets could, as a result of the operation of these rules, be treated as the owners of the assets, resulting in potential CGT implications. To address this, the beneficiaries could be treated as having always owned the assets — so that a CGT event does not happen when they start to be treated as owning the asset.

Trustee obligations and other tax consequences

If bare trusts are carved out from the operation of a rewritten Division 6, the trustee of a trust treated as a bare trust could still retain some Division 6 obligations because of the need to ensure that the beneficiary meets their tax obligations and direct reporting obligations to the Commissioner such as:

- withholding from beneficiaries' amounts;
- providing the beneficiary with the information necessary to complete their tax return; and

- providing an Annual Investment Income Report to the Commissioner.[21]

Goods and services tax

The Government has previously announced that the GST law will be amended to remove doubt surrounding the GST liabilities and entitlements of bare trusts.[22] This decision followed a recommendation by the Board where it concluded that there is ambiguity as to whether the trust or beneficiary is liable for the GST consequences of transactions and doubts about how the GST law applies to bare trusts and similar types of nominee arrangements.[23]

For consistency, transactions carried out by the trustee of a trust with the abovementioned characteristics of a bare trust will be treated as having been carried out by the beneficiary for GST purposes.

Following the Board's report, the Government released a discussion paper that proposed that supplies made by a bare trust (and trusts that operate similarly to bare trusts) be treated as being made by the beneficiary.[24] The paper discussed an alternative proposal to treat the trustee as an agent for the beneficiary, of which submissions were unsupportive. The paper also included focus questions in respect of the impacts of the 'look-through' approach on instalment warrants and IDPS.

In response to the discussion paper, submissions noted that IDPS are sets of bare trusts, and there could be practical difficulties in requiring individual investors to register and account for GST directly.[25] Administrative and compliance savings could be achieved by excluding IDPS from the 'look-through' approach and allowing the trustee to be responsible for the GST consequences of the transactions. Depending on their structure, individual instalment warrants may not be bare trusts. However, there would be compliance costs savings if the beneficiary is regarded as having carried out the transactions for GST purposes.

Based on these earlier submissions there would appear to be support for some variation to the proposed bare trust definition for GST purposes.

Question 11

Should bare trusts be ignored for the purposes of GST? If the extension were not to apply to all bare trust like arrangements, how should they be distinguished?

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[21] See regulation 56 of the *Income Tax Regulations 1936*.

[22] The Hon Chris Bowen MP (then Assistant Treasurer and Minister for Competition Policy and Consumer Affairs), *Government Response to Board of Taxation Review of GST Administration*, Media Release number 42, 12 May 2009.

[23] Board of Taxation, *Review of the Legal Framework for the Administration of the Goods and Services Tax*: *A Report to the Assistant Treasurer and Minister for Competition Policy and Consumer Affairs*, December 2008.

[24] The Treasury, *Implementation of the recommendations of the Board of Taxation's review of the legal framework for the administration of the GST Second consultation paper*, Commonwealth of Australia, September 2009.

[25] Submissions available at: http://archive.treasury.gov.au/contentitem.asp?ContentID=1717&NavID=037.

Appendix A

Detailed example — discretionary trust

Purpose

This example demonstrates how the proposed EBM and PAM would apply to a discretionary trust that is carrying on a business. The current law is also applied to the facts.

Facts

The Colour Trust operates a printing business that sells its products on 30 day terms and applies accrual accounting. The trust is not audited, but prepares special purpose financial reports on an annual basis.

The trust deed of the Colour Trust permits the trustee to make both income and capital distributions. It does not contain a definition of 'income'. Income, and occasionally capital, are typically only appointed to two beneficiaries, being Mrs Ruby, and Silver Australia Pty Ltd. There are no default beneficiaries.

For the 20X1 and 20X2 income years, the Colour Trust derived the following amounts of income and incurred the following expenses.

Table 1

Income from activities	**20X1**	**20X2**
Trading sales	580,000	720,000
Franked dividends	10,605	10,185
Interest on bank account	4,850	5,450
Total income from activities	**595,455**	**735,635**
Expenses from activities		
Costs of goods sold	340,000	425,000
Doubtful debts[26]	3,500	2,250
Accrued expenses[27]	25,000	30,000
Legal expenses	0	60,000
Depreciation expense[28]	15,000	15,000

26 Of the doubtful debts provided for, $1,500 were written off as bad in 20X1, and $1,250 were written off as bad in 20X2. These are not separately expensed.

27 These expenses relate to superannuation of administration staff, as well as other administration expenses that have not yet been incurred for tax purposes. They are incurred for tax purposes in the next income year.

28 Depreciation relates to the amortisation of office equipment used by administration staff.

Expenses from activities		
Salary and wages[29]	65,000	70,000
Other expenses[30]	105,000	120,000
Total expenses from activities	**553,500**	**722,250**
Total profit/(loss)	**41,955**	**13,385**

[29] Relates to administration expenses.
[30] Relates to administration expenses.

Applying the EBM

1. Calculate the trust's taxable income as if the trust is a resident taxpayer.

For the relevant income years, Colour Trust makes a number of adjustments to its profit and loss amount to determine its taxable income.

Table 2:

Total profit/(loss)	**41,955**	**13,385**
Franking Credits	4,545	4,365
Trading stock — market selling adjustment (s.70-40)	10,000	(10,000)
Provision for doubtful debts (not deductible)	2,000	1,000
Accrued expenses (not deductible)	25,000	5,000
Legal expenses capital (not deductible)	0	60,000
Tax depreciation	(75,000)	(37,500)
Accounting depreciation	15,000	15,000
Accrued interest income	(4,850)	(5,450)
Interest received	0	4,850
Total tax adjustments	**(23,305)**	**37,265**
Total taxable income/(loss)	**18,650**	**50,650**

The Colour Trust has taxable income of $18,650 for 20X1 and $50,650 for 20X2.

2. Identify the components of the trust's taxable income.

Deductions have been allocated on a fair and reasonable basis in the following way:

- The cost of goods sold and bad debts written off have been applied against the assessable business income of the trust, as those expenses relate to that particular type of income.
- All other deductions have been treated as general deductions and have been allocated against all components of assessable income. In this case, this has been based on the proportion that each assessable income amount (net of related deductions) bears to the total assessable income of the trust.
- General deductions have not been applied to reduce the assessable gross up on a franked distribution — to the extent possible.

The following tables demonstrate the calculation of the Colour Trust's taxable income after the allocation of deductions against the components of assessable income:

Table 3

20X1 Taxable income components net of related deductions	**Amount 20X1**	**Business Income**	**Franked Dividends**
Trading Sales	580,000	580,000	
Cost of goods sold	(330,000)	(330,000)	
Bad debts written off	(1,500)	(1,500)	
Franked dividends	10,605		10,605
Total assessable income excluding franking credits, net of related deductions	259,105	248,500	10,605
	100.00%	95.91%	4.09%
Franking credits (gross up)	4,545		4,545
Total assessable income net of related deductions	**263,650**	**248,500**	**15,150**
General deductions			
Depreciation	75,000	71,930	3,070
Salary and Wages	65,000	62,340	2,660
Other expenses	105,000	100,702	4,298
Total general deductions	245,000	234,972	10,028
Total 20X1 net taxable income components	**18,650**	**13,528**	**5,122**

Table 4

20X2 Taxable income components net of related deductions	Amount 20X2	Business Income	Franked Dividends	Interest
Trading Sales	720,000	720,000		
Cost of goods sold	(435,000)	(435,000)		
Bad debts written off	(1,250)	(1,250)		
Franked dividends	10,185		10,185	
Interest income	4,850			4,850
Total assessable income excluding franking credits, net of related deductions	**298,785**	**283,750**	**10,185**	**4,850**
	100.00%	**94.97%**	**3.41%**	**1.62%**
Franking credits (gross up)	4,365		4,365	
Total assessable income net of related deductions	**303,150**	**283,750**	**14,550**	**4,850**
General deductions				
Depreciation	37,500	35,613	1,278	609
Salary and Wages	70,000	66,478	2,386	1,136
Expenses accrued prior-year (now incurred)	25,000	23,742	852	406
Other expenses	120,000	113,962	4,091	1,948
Total general deductions	**252,500**	**239,795**	**8,607**	**4,099**
Total 20X2 net taxable income components	**50,650**	**43,955**	**5,943**	**751**

3. Distribute and allocate amounts representing taxable income.

The trustee of the Colour Trust will reduce its taxable income by the amount of any distributions and allocations. These amounts, which have been calculated on a net basis, are as follows:

Table 5

Assessable trust amounts	20X1	20X2
Trading Sales	580,000	720,000
Franked Dividends	10,605	10,185
Interest Income	0	4,850[31]
Total assessable trust amounts	**590,605**	**735,035**
Deductible trust expenses		
Cost of goods sold	340,000[32]	425,000
Bad debts written off	1,500	1,250
Prior year accrued expenses (now deductible)	0	25,000[33]
Depreciation expense	15,000	15,000
Salary and Wages	65,000	70,000
Other expenses	105,000	120,000
Total deductible trust expenses/losses	**526,500**	**656,250**
Distributable taxable income	**64,105**	**78,785**

20X1

For 20X1, the Colour Trust has $64,105 that it has recognised in its accounts and which represents taxable income of the trust. However, largely due to depreciation, and because part of the taxable income includes a gross up for franking credits, it only needs to distribute an amount representing taxable income equal to $14,105 (20X1 taxable income less franking credits). For trust purposes, it has income of $41,955 available for distribution.

On 20 August, the trustee resolves to distribute:

- $5,455 to Mrs Ruby, all of which represents taxable income (specifically, $577 represents taxable franked distributions and $4,878 represent taxable business income); and
- $8,650 to Silver Australia Pty Ltd that represents taxable business income.

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[31] It does not matter that this amount was recognised for trust purposes, or otherwise came home to the trust, in a prior income year.

[32] Even though the amount recognised as an expense this year by the trust exceeds that which is deductible for tax purposes, these are expenses (cost of goods sold) which have been taken into account in the trust's taxable income and which are amounts that have been recognised by the trustee as a loss or outgoing of the trust. The full amount represents an amount referable to the taxable income of the trust that cannot be distributed (even though different methodologies have been adopted for trust accounting and tax purposes).

[33] It does not matter that the amount of this deduction was recognised as an expense in a prior period.

$4,545, being the gross up for franking credits, automatically flows to Mrs Ruby.

The trustee notifies the beneficiaries of these distributions and allocations. With the beneficiaries' implied consent, the trustee credits loan accounts in their names. The trustee reduces its taxable income by $18,650, leaving it with taxable income of $0.

The trustee accumulates the remaining $27,850 of trust income.

20X2

For 20X2, the Colour Trust has $78,785 that it has recognised in its accounts and which represents taxable income of the trust. However, largely due to depreciation, and because part of the taxable income includes a gross up for franking credits, it only needs to distribute an amount representing taxable income equal to $46,285 (20X2 taxable income less franking credits). For trust purposes however, it only has income of $13,385 available for distribution.

On 11 August, the trustee resolved to distribute:

- $5,635 to Mrs Ruby, all of which represents taxable income (specifically, $1,578 that represents taxable franked distributions, $751 that represents taxable interest receipts, and $3,306 that represents taxable business income);
- $7,750 to Silver Australia Pty Ltd that represents taxable business income (which is sourced from trust income); and
- $32,900 to Silver Australia Pty Ltd that represents taxable business income (which is sourced from trust capital).

$4,365, being the gross up for franking credits, automatically flows to Mrs Ruby.

The trustee notified the beneficiaries of these distributions, and, with their implied consent, credited loan accounts in their names. The trustee reduces its taxable income by $50,650, leaving it with taxable income of $0.

While the Colour Trust had insufficient accounting profit to make these distributions, the difference was sourced from trust capital. This is permissible, but only to the extent that the total amounts distributed do not exceed the trust amounts referable to taxable income ($78,785). The reason that the trust income available for distribution was less than the taxable income of the trust was primarily due to non-deductible expenditure of $60,000 (for legal expenses).

Question 12

The distribution principle has been applied flexibly in the detailed EBM example to enable the difference attributable to the legal expenses to be assessed to the beneficiaries, as this is considered a desirable outcome. While this may be the desired outcome, does the principle as developed actually accommodate this outcome?

a) Should the principle be modified to deal with such amounts?

b) How can the principle be modified to deal with such amounts?

c) What other types of amounts might cause the same problems?

4. Beneficiaries are assessed on amounts distributed and allocated to them.

20X1

Mrs Ruby is assessable on $10,000 (which includes the gross up for franking credits) and is entitled to franking credits of $4,545.

Silver Australia Pty Ltd is assessable on $8,650.

20X2

Mrs Ruby is assessable on $10,000 (which includes the gross up for franking credits) and is entitled to franking credits of $4,365.

Silver Australia Pty Ltd is assessable on $40,650.

5. The trustee is assessed on the remaining taxable income.

20X1

The trustee is assessed on $0. This will be deemed to be a nil assessment.

20X2

The trustee is assessed on $0. This will be deemed to be a nil assessment.

Applying the PAM

1. Calculate the trust profit.

The Colour Trust's trust profit is as follows:

20X1

$41,955[34]

20X2

$13,385[35]

2. Determine the different classes of trust profit. At a minimum, trustees would typically need to keep separate classes in respect of their exempt income and NANE income. This ensures that a beneficiary that only receives exempt income or NANE will not be assessed on any part of the trust's taxable income. Other amounts can be placed in a single class, or separated into two or more classes.

20X1

In order to facilitate streaming, the trustee determines that for the 20X1 year there are three classes of trust profit; those being business income, interest income and dividend income.

20X2

Similarly, for the 20X2 year, the trustee determines that there are three classes of trust profit; those being business income, interest income and dividend income.

3. Allocate the trust profit to classes. That is, calculate the class amounts.

For the purpose of determining class amounts, the accrued expenses, depreciation expense, salary and wages and other expenses have all been treated as general expenses and allocated to the income classes based on the proportion of the gross income of each class to total income.[36]

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[34] See Table 1 above being the total income from activities ($595,455) less total expenses from activities ($553,500).

[35] See Table 1 above being the total income from activities ($735,635) less total expenses from activities ($772,250).

[36] For the 20X1 income year, general expenses have been allocated in the following way: Interest income $4,850/($595,455-$340,000-$3,500)) =1.92 per cent; Business income ($580,000-$340,000-$3,500)/($595,455-$340,000-$3,500) = 93.87 per cent. Franked dividend income($10,605/($595,455-$340,000-$3,500) = 4.21 per cent For the 20X2 income year, general expenses have been allocated in the following way: Interest income ($5,455/$735,635-$425,000-$2,250) = 1.77 per cent; Business income ($720,000-$425,000-$2,250)/($735,635-$425,000-$2,250) = 94.93 per cent, Franked dividend income ($10,185)/($735,635-$425,000-$2,250) = 3.30 per cent.

Table 6

Trust Income	Trust Profit for 20X1	Business income class	Interest income class	Franked Dividend income class	Trust Profit for 20X2	Business income class	Interest income class	Franked Dividend income class
Trading sales	580,000	580,000			720,000	720,000		
Interest on bank account	4,850		4,850		5,450		5,450	
Dividend income	10,605			10,605	10,185			10,185
Total trust income	**595,455**	**580,000**	**4,850**	**10,605**	**735,635**	**720,000**	**5,450**	**10,185**
Directly related expenses								
Cost of goods sold	340,000	340,000			425,000	425,000		
Doubtful debts	3,500	3,500			2,250	2,250		
Trust income net of directly related expenses	251,955	236,500	4,850	10,605	308,385	292,750	5,450	10,185
		93.87%	1.92%	4.21%		94.93%	1.77%	3.3%
Accrued expenses	25,000	23,466	481	1,052	30,000	28,479	530	991
Legal expenses	0	0	0	0	60,000	56,958	1,060	1,982
Depreciation deductions	15,000	14,080	289	631	15,000	14,240	265	495
Salary and wages	65,000	61,013	1,251	2,736	70,000	66,451	1,237	2,312
Other expenses	105,000	98,559	2,021	4,420	120,000	113,916	2,121	3,963
Total expenses from activities	553,500	540,618	4,042	8,839	722,250	707,294	5,213	9,743

Total class amounts	**41,955**	**39,382**	**808**	**1,766**	**13,385**	**12,706**	**237**	**442**

4. Determine the proportions of the class amounts to which beneficiaries are presently entitled.

20X1

The trustee resolves to distribute $10,000 of trust profit to Mrs Ruby but only to the extent that the $10,000 can be met out of franked dividends and interest. The remainder of the profit will be distributed to Silver Australia Pty Ltd.

As a result of the resolution, Mrs Ruby is made presently entitled to 100 per cent of the interest income class ($808), 100 per cent of the franked dividend income class ($1,766), and $7,426 of business income which amounts to a total distribution of $10,000.

Silver Australia Pty Ltd is made presently entitled to the balance of the business income being $31,955.

The trustee notifies the beneficiaries of their entitlements and, with their implied consent, credits loan accounts in their names.

20X2

In 20X2, the trustee resolves to distribute $10,000 to Mrs Ruby comprising 100 per cent of the interest income and 100 per cent of the dividend income, with the balance to be met out of business income. The trustee also resolves to distribute the balance of business income to Red Australia Pty Ltd.

This results in Mrs Ruby having a present entitlement to business income of $9,321, interest income of $237, and franked distributions of $442.

Silver Australia Pty Ltd is made presently entitled to $3,385.

The trustee notifies the beneficiaries of this and, with their implied consent, credits loan accounts in their names.

5. Calculate the taxable income of the trust as if the trust were a resident taxpayer.

20X1

As shown above in Table 2, the taxable income of the Colour Trust for the 20X1 year is $18,650.

20X2

As shown above in Table 2, the taxable income of the Colour Trust for 20X2 year is $50,650.

6. Allocate the trust's taxable income to the classes maintained by the trustee (if applicable). That is, separate the trust's taxable income into specific assessable amounts net of relevant deductions that accord with the classes maintained for trust purposes.

Deductions have been allocated on a fair and reasonable basis in the following way:

- The cost of goods sold and bad debts written off have been applied against the assessable business income of the trust, as those expenses relate to that particular type of income.
- All other deductions have been treated as general deductions and have been allocated against all components of assessable income. In this case, this has been based on the proportion that each assessable income amount (net of related deductions) bears to the total assessable income of the trust.
- General deductions are not applied to reduce the assessable gross up on a franked distribution — to the extent possible.

Tables 3 and 4 above demonstrate the calculation of the Colour Trust's taxable income after the allocation of deductions against the components (or here, classes) of assessable income. In summary, the taxable income referable to each class is as follows:

Table 7

Income from activities	**Taxable income for 20X1**	**Business income class**	**Interest income class**	**Franked Dividend class**
Trading sales	580,000	580,000	0	0
Interest on bank account	0	0	0	0
Franked dividend	10,605	0	0	10,605
Total assessable income (excluding franking credits)	590,605	580,000	0	10,605

Deductible specific expenses	331,500	331,500	0	0
Deductible general expenses	245,000	234,972	0	10,028
Total deductible expenses	576,500	566,472	0	10,028
Franking credits (gross-up)	4,545			4,545
Total net taxable income per class	18,650	13,528	0	5,122

Table 8

Income from activities	**Taxable income for 20X2**	**Business income class**	**Interest income class**	**Franked Dividend class**
Trading sales	720,000	720,000	0	0
Interest on bank account	4,850	0	4,850	0
Franked dividend	10,185	0	0	10,185
Total assessable income (excluding franking credits)	735,035	720,000	4,850	10,185
Deductible specific expenses	436,250	436,250	0	0
Deductible general expenses	252,000	239,794	4,099	8,607
Total deductible expenses	688,250	676,044	4,099	8,607
Franking credits (gross-up)	4,365	0	0	4,365
Total net taxable income per class	50,150	43,956	751	5,943

7. The beneficiaries are assessed on the trust's taxable income based on the proportionate share of the class amounts they are entitled to.

The following table demonstrates the allocation of taxable amounts to beneficiaries based on the their proportionate entitlement to class trust amounts.

Table 9

Item		20X1	Business income class	Interest income class	Franked dividend class	20X2	Business income class	Interest income class	Franked dividend class
Total trust profit class amounts		**41,955**	**39,381**	**808**	**1,766**	**13,385**	**12,706**	**237**	**442**
Entitlement									
	Mrs Ruby		18.86%	100%	100%		73.36%	100%	100%-
	Silver Australia Pty Ltd		81.14%	0	0		26.64%	0	0
	Trustee		0	0	0		0	0	0
Total net taxable income per class		**18,650**	**13,528**	**0**	**5,122**	**50,650**	**43,956**	**751**	**5,943**
Assessment									
	Mrs Ruby	0	2,551	0	**5,122**		32,246	**751**	**5,943**
	Silver Australia Pty Ltd	0	**10,977**	0	0		11,710	0	0
	Trustee	0	0	0	0		0	0	0
Total		**18,650**	**13,528**	**0**	**5,122**	**50,650**	**43,956**	**751**	**5,943**

8. The trustee is assessed on the remaining taxable income.

The remaining taxable income is $0.

Applying the current law

Under the current law, a beneficiary who is presently entitled to a share of the income of the trust estate is assessed on that same share of the trust's taxable income. Franked distributions and capital gains may be streamed to particular beneficiaries by making them specifically entitled to those amounts.[37]

For these purposes, on 30 June in both of the income years the trustee resolves to distribute the trust's income as follows:

- $10,000 to Mrs Ruby (comprising franked dividends, to the extent possible);
- the balance to Red Australia Pty Ltd.

The trustee has kept appropriate accounts and records so Mrs Ruby is specifically entitled to franked dividends.

1. Calculate the taxable income (unmodified by Division 6E)

20X1

As shown above in Table 2, the taxable income of the Colour Trust is $18,650.

20X2

As shown above in Table 2, the taxable income of the Colour Trust is $50,650.

2. Calculate the income of the trust estate (unmodified by Division 6E)

This is the income of the trust to which beneficiaries may be made presently entitled, generally referred to as the trust's distributable income.

The determination of the income of a trust is grounded in trust law and focuses on the receipts and outgoings of the trust for the income year. The reference to trust law in this context encompasses various elements, including the general law, statutory law, trust accounting principles, the trust deed, and the actions taken by the trustee in accordance with the deed and the settlor's intention.[38]

It has been assumed for the purpose of this example that its distributable income is equal to its accounting profit, given that the trust deed does not define income or distributable income. In other words, it has been accepted that accounts prepared on an accruals basis reflect the trust's distributable income for the relevant years. This means, for example, that interest accrued but not yet received is included in distributable income; and distributable income is reduced by accounting (rather than tax) depreciation and the non-deductible legal expenses.

[37] Divisions 6 and 6E of the ITAA 1936 and Subdivisions 207-B and 115-C of the ITAA 1997.
[38] Draft Taxation Ruling TR 2012/D1, paragraph 64.

The income of the Colour Trust estate is (as in Table 1 above) therefore:

20X1

$41,955

20X2

$13,385

These are the amounts that would need to be distributed to beneficiaries in order to avoid a trustee assessment. This compares with the amounts distributed, allocated, or to which beneficiaries are presently entitled under the EBM and PAM as follows:

Table 10:

	20X1	20X2	Total
Current law	41,955	13,385	55,340
EBM	18,650	50,650	69,300
PAM	41,955	13,385	55,340

3. Apply Division 6 (unmodified by Division 6E)

The first step is to apply Division 6, unmodified by Division 6E — that is, ignoring for the moment that the trust has franked distributions that the trustee has sought to stream to Mrs Ruby.

Table 11:

Year	Beneficiary	Present entitlement	Division 6 percentage	s 97 share of taxable income
20X1	Mrs Ruby	10,000	23.84% (10,000/41,955)	4,446
20X1	Silver Australia Pty Ltd	31,955	76.16% (31,955/41,955)	14,204
20X2	Mrs Ruby	10,000	74.71% (10,000/13,385)	37,841
20X2	Silver Australia Pty Ltd	3,385	25.29% (3,385/13,385)	12,809

4. Calculating Mrs Ruby's specific entitlement to the franked dividends

The trustee has sought to stream the franked dividends (that is, a portion of them) to Mrs Ruby in each income year.

The net financial benefit referable to the franked dividends in each income year is equal to the amount of the dividend (excluding franking credits) because there are no directly relevant expenses that can be taken into account in working out the net financial benefit:[39]

Table 12:

20X1	20X2
10,605	10,185

Given that there is no requirement to reduce entitlements to franked distributions by general expenses, Mrs Ruby's share of the net financial benefit referable to the franked dividends is:

Table 13:

20X1	10,000/10,605	= 0.94
20X2	10,000/10,185	= 0.98

Mrs Ruby's share of the franked distribution to which she is specifically entitled is:

Table 14:

20X1	\$10,000/\$10,605	94% fraction of the franked distribution
20X2	\$10,000/\$10,185	98% fraction of the franked distribution

5. Calculate the beneficiaries' adjusted Division 6 percentage

This is the percentage of income to which beneficiaries are entitled ignoring the franked dividends to which Mrs Ruby is specifically entitled.

In this example the adjusted income of the trust in year 20X1 is \$41,955 less the \$10,000 to which Mrs Ruby is specifically entitled (\$31,955); and in year 20X2 is \$13,385 less the \$10,000 to which Mrs Ruby is specifically entitled (\$3,385).

[39] The net financial benefit referable to a franked distribution is the gross financial benefit reduced by directly relevant expenses only. There are no expenses directly relevant to the franked dividends in either year.

Table 15:

Year	Beneficiary	Present entitlement to 'adjusted income'	Share of 'adjusted income'
20X1	Mrs Ruby	0	0
20X1	Silver Australia Pty Ltd	31,955	100%
20X2	Mrs Ruby	0	0
20X2	Silver Australia Pty Ltd	3,385	100%

6. Apply Subdivision 207-B

This demonstrates how much of the franked dividends each beneficiary is taken to have (and associated franking credits), based on their specific entitlement to franked dividends and their (adjusted Division 6 percentage) share of those franked dividends to which no beneficiary is specifically entitled:

Table 16

20X1	Mrs Ruby	Silver Australia Pty Ltd
Specific entitlement	10,000	0
Adjusted Division 6 percentage share	0	605
Total	10,000 (94%)	605 (6%)

Under 207-B, each beneficiary is also assessed on a corresponding share of the franking credit as follows:

- Mrs Ruby: 94 per cent of $4,345 franking credit = $4,286
- Silver Australia Pty Ltd: 6 per cent of $4,345 franking credit = $259

Table 17

20X2	Mrs Red	Red Australia Pty Ltd
Specific entitlement	10,000	0
Adjusted Division 6 percentage share	0	185
Total	10,000	185

Under 207-B, each beneficiary is also assessed on a corresponding share of the franking credit as follows:

- Mrs Ruby: 98 per cent of $4,365 franking credit = $4,286; and
- Silver Australia Pty Ltd: 2 per cent of $4,365 franking credit = $79.

7. Recalculate assessable amounts using Division 6E

The Division 6E income is $31,350 for 20X1 (trust income of $41,955 less $10,605 franked distributions) and $3,200 for 20X2 ($13,385 trust income less $10,185 franked distributions).

The Division 6E taxable income is $3,500 for 20X1 ($18,650 taxable income, less $10,605 franked dividends and $4,545 franking credits) and $36,100 for 20X2 ($50,650 less $10,185 franked dividends and $4,365 franking credits).

Mrs Ruby's present entitlement to the Division 6E income, ignoring her present entitlement to the franked dividends to which she is specifically entitled in each year, is $0.

Silver Australia's Division 6E present entitlement is 100 per cent in each year.

The modified amounts assessable under Division 6 are as follows:

Table 18: 20X1

Beneficiary	Division 6E present entitlement	Share of Division 6E income	s 97 assessable amount
Mrs Ruby	0	0	0
Silver Australia Pty Ltd	100%	31,350	3,500

Table 19: 20X2

Beneficiary	Division 6E present entitlement	Share of Division 6E income	s 97 assessable amount
Mrs Ruby	0	0	0
Silver Australia Pty Ltd	100%	3,200	36,100

8. Overall result

Table 20: 20X1

Amount	Mrs Red	Red Australia Pty Ltd
Adjusted s 97 assessable amount	0	3,500
Attributable franked distribution	10.000	605
Franking credit	4,286	259
Total	14,286	4,364

Table 21: 20X2

Amount	**Mrs Ruby**	**Silver Australia Pty Ltd**
Adjusted s 97 assessable amount	0	36,100
Attributable franked distribution	10,000	185
Franking credit	4,286	79
Total	14,286	36,364

Appendix B

Diagrams

Economic Benefits Model

STEP 1 — **Calculate the trust's taxable income as if the trust is a resident taxpayer.**

STEP 2 — **Identify the components of the trust's taxable income.**

For example:

'Capital gains'	'Dividends'	'Rent'
Net capital gains ($100)	Franked distribution ($100) - deduction ($10) = $90 dividends	Ordinary income from rent ($500) - deductions ($300) = $200 ordinary income

Note: In this example, there are no timing differences or notional amounts other than the gross-up portion of the franked distribution.

STEP 3 — **Distribute and allocate amounts representing taxable income.**

For example:

Beneficiary A:	Beneficiary B:	Beneficiary C:
Distribution: $100 capital gains (That is, $200 gross capital gains)	Distribution: $90 franked distributions (inlcuding a gross up of $30 for attached franking credits)	Distribution: $170 rent

STEP 4 — **Beneficiaries are assessed on amounts distributed and allocated to them.**

For example:

Beneficiary A:	Beneficiary B:	Beneficiary C:
Assessed on: $100 capital gain (grossed up to $200 and then reduced again)	Assessed on: $90 (including a $30 franking credit)	Assessed on: $170

STEP 5 — **The trustee is assessed on the remaining taxable income.**

For example:

Trustee assessed on $30

Proportionate Assessment Model

STEP 1

Calculate the trust profit.

STEP 2

Determine the different classes of trust profit.
At a minimum, trustees must keep separate classes in respect of their exempt income and NANE income. This ensures that a beneficiary that only receives exempt income or NANE will not be assessed on any part of the trust's taxable income.
Other amounts can either be placed in a single class, or separated into two or more classes.

For example:

- Class 1: Rent
- Class 2: Business income
- Class 3: Capital gains

STEP 3

Allocate the trust profit to classes. That is, calculate the class amounts.

For example:

- Class 1: $100
- Class 2: $200
- Class 3: $300

STEP 4

Determine the proportions of the trust profit or class amounts to which beneficiaries are presently entitled.

For example:

- Beneficiary A: 80% of class 1
- Beneficiary B: 100 % of class 2
- Beneficiary C: 20 % of class 1 + 50% of class 3

STEP 5

Calculate the taxable income of the trust as if the trust were a resident taxpayer.

STEP 6

Allocate the trust's taxable income to the classes maintained by the trustee (if applicable). That is, separate the trust's taxable income into specific assessable amounts net of relevant deductions that accord with the classes maintained for trust purposes.

For example:

- Class 1: Ordinary income from rent ($500) - deductions ($300) = $200 ordinary income
- Class 2: Ordinary income from trading stock ($1,000) - deductions ($800) = $200 ordinary income
- Class 3: Net (discount) capital gains ($150) - deductions ($0) = $150 capital gains

STEP 7

The beneficiaries are assessed on the trust's taxable income based on the proportionate share of the trust profit or class amounts they are entitled to.

For example:

- Beneficiary A: Assessed on $200 x 80% = $160
- Beneficiary B: Assessed on $200 x 100% = $200
- Beneficiary C: Assessed on $200 x 20% + $150 x 50% = $115

STEP 8

The trustee is assessed on the remaining taxable income.

For example:

Trustee assessed on $150 x 50% = $75, grossed up for discount (not available to trustee) to $150 capital gains

Appendix C

Summary of consultation questions

Question 1:

Would introducing a ‘fair and reasonable basis’ principle into the legislation provide additional certainty for trustees and beneficiaries? What rules would be required to implement this principle?

Question 2:

Would it be appropriate to extend the time for determining entitlements beyond 31 August for certain classes of trusts, where it is reasonable to expect that beneficiaries have a lodgement date later than 31 October? What features should such trusts have? Should the trustee be required to obtain the agreement of all beneficiaries? If so, should this be done on and opt-in, or opt-out basis?

Question 3:

a) How could the integrity, regulatory and fiscal issues associated with a lower rate be addressed without increasing complexity?

b) Would a ‘tax and credit system’ (akin to franking credits) increase compliance costs and be too similar to taxing trusts like companies on accumulations?

c) What else could be done to reduce the practical impact of trustee assessments?

Question 4

Should trustees be able to fund distributions from other sources if an amount representing taxable income has not been recognised in its accounts, or otherwise been received or come home to the trust (bearing in mind the trustee’s ability to allocate amounts as described below)?

Question 5

The intent of the definition of trust profit used for the PAM is to capture all accretions to the trust estate excluding contributions of capital. Does the definition of ‘trust profit’ achieve that? If not, how can it be improved?

Question 6

Should the trustee be able to change the classes from year to year? What limits, if any, could be put in place to prevent unintended consequences?

Question 7

Should there be a specific entitlement rule to deal with capital gains?

Question 8

Should any new model for taxing trust income be treated as an exclusive code? If so, why? If not, to what extent should trust distributions otherwise be taken into account for tax purposes?

Question 9

Should bare trust type arrangements be excluded from the new model for taxing trust income?

Question 10

Are the characteristics of bare trust type arrangements sufficient to describe and possibly define such arrangements?

Question 11

Should bare trusts be ignored for the purposes of GST? If the extension were not to apply to all bare trust like arrangements, how should they be distinguished?

Question 12

The distribution principle has been applied flexibly in the detailed EBM example to enable the difference attributable to the legal expenses to be assessed to the beneficiaries, as this is considered a desirable outcome. While this may be the desired outcome, does the principle as developed actually accommodate this outcome?

a) Should the principle be modified to deal with such amounts?

b) How can the principle be modified to deal with such amounts?

c) What other types of amounts might cause the same problems?