

Government to Fix some Problems with Taxation of Trusts

The Federal Government has released a Treasury Discussion Paper entitled "Improving the taxation of trust income".

The Government is proposing interim amendments to the tax law as a stop-gap attempt to deal with the problems caused by the High Court's Bamford decision. These amendments would apply retrospectively from 1 July 2010. These interim measures will be later followed by a total update of the tax law for trusts with a rewrite into the Income Tax Assessment Act 1997 (ITAA 1997), as announced by the Assistant Treasurer on 16 December 2010.

The discussion paper identifies the following two stop-gap amendments:

- ▶ Better align the 'income of the trust estate' with the taxable income of the trust to ensure that only the beneficiaries who are entitled to the income and gains of the trust are taxed on that income and /or gains; and
- ▶ Ensure capital gains and franking offsets can be streamed to specific beneficiaries for tax purposes (where the trust deed allows streaming of the distributions).

BAMFORD DECISION

The High Court's Bamford decision and some other recent trust tax law cases highlighted the problems with the taxation of trust estates. In particular what constitutes 'distributable income' of the trust estate for the purposes of section 97 of the ITAA 1936, and on what basis the beneficiaries are to be taxed on that income.

In Bamford, the High Court clarified that:

- ▶ 'Income of the trust estate' is distributable income as determined by trust law; and
- ▶ Beneficiaries are taxed on a share of the trusts taxable income in the same proportion as their 'share' of the distributable trust income to which they are beneficially entitled.

This decision created or highlighted the following problems with the current law for taxing trusts:

- ▶ Mismatch between assessable and trust income - By adopting the proportionate approach, there may be a mismatch between amounts beneficiaries are entitled to receive under trust law and amounts they are ultimately taxed on i.e. they may be taxed on amounts they do not in fact receive in a trust distribution. It also creates opportunities to manipulate tax liabilities.

- ▶ Problems with Streaming - Where trust income is comprised of different types or categories, e.g. foreign income, capital gains and franked dividends, can they be distributed or 'streamed' to certain beneficiaries at the expense of others for tax purposes? The Bamford decision has effectively brought to an end the ability to stream most types of trust income.

Proposed Fix

To partially fix these problems, the Government will amend the law to:

- ▶ Better align the key concept of 'income of the trust estate' (i.e. distributable income) with the tax law concept of 'net income of the trust estate' (taxable income) so as to reduce anomalous outcomes and opportunities to manipulate tax liabilities; and
- ▶ Ensure capital gains and franked distributions (including the attached franking credits) can be streamed to particular beneficiaries.

Application Date

The proposed amendments will apply for the 2010-2011 tax year and future tax years i.e. from 1 July 2010.

Aligning trust income with taxable income

The Government is proposing ways to better align the trust law concept of distributable income with the tax law concept of 'taxable income' to remove the problems of the wrong beneficiaries being taxed or not taxed on the share of the income or capital gains they are entitled to.

The Government proposes to legislate a definition of the phrase 'income of the trust estate' (distributable income) for the purposes of Division 6 ITAA 1936. The Government proposes three possible approaches to defining distributable income as follows:

1. Define Distributable Income as Tax Income

This option defines distributable income by equating it with the notional taxable income of the trust with some adjustments. This would result in the beneficiaries, who are entitled to the income or gains, being taxed on that income or gains. However, adjustments would be needed to take into account both notional income and notional expense amounts. The following are examples of adjustments that would need to be considered:

- ▶ Whether amounts such as franking credits and deemed dividends should be treated as notional income and therefore excluded from distributable income.
- ▶ Whether amounts such as new business investment assets under Division 41 of the ITAA 1997 should be treated as notional expenses and disregarded in calculating distributable income.
- ▶ Whether the discount amount of a net capital gain should also be included in the distributable income of the trust.

There may also need to be legislative amendments to ensure the trust's exempt and non-assessable non-exempt income is allocated appropriately amongst beneficiaries with entitlements to those amounts.

This method will help most discretionary trusts but it may be detrimental for many fixed and unit trusts. In particular, many Managed Investment Trusts (MIT) currently retain capital profits in the trust for reinvestment or repayment of debt. Under this proposal, the trustees of such MIT's could be assessed on the capital gains without any CGT discount at 46.5%.

2. Defining Distributable Income Using Accounting Concepts (Accounting Standards)

Under this option, the trustee would be required to apply accounting standards in preparing the accounts. For example, distributable income could be defined as equal to a trust's accounting profit for the relevant income year, as determined in accordance with generally accepted accounting principles (GAAPs).

One of the drawbacks to this approach is that it may increase complexity and compliance costs as not all trustees currently apply GAAP. Further, it does not resolve the mismatches between distributable income and taxable income identified in the Bamford case, which will remain a possibility.

3. Define Distributable Income to Specifically Include Capital Gains

Under the approach, the trust deed will determine what constitutes distributable income provided the deed specifies that any capital gains made by the trust will be included in its distributable income for that income year. Where the trust's deed does not provide for the trust's capital gains to be included in its distributable income, these amounts could be included for tax purposes.

The Government believes that while this method will reduce the scope for unfair tax outcomes, a specific anti-avoidance provision may be required to ensure the tax liabilities of beneficiaries cannot be manipulated. For example, where the beneficiaries' entitlements under the trust deed differ significantly from the amount of the trust's taxable income they are assessed on, adjustments would have to be made to ensure they are assessed on the appropriate amount of the taxable trust income.

The discussion paper does not give many details of this option but it appears it may cause similar problems for MIT's mentioned above that want to retail capital gains in the trust for reinvestment etc.

STREAMING FRANKED DISTRIBUTIONS AND NET CAPITAL GAINS

The Government agrees the proportionate approach creates difficulties in streaming certain categories of income, gains or other tax attributes to specific beneficiaries.

To resolve some of these uncertainties, the Government will amend the Tax Act to ensure franked distributions and capital gains can be streamed for tax purposes.

Streaming Franked Distributions and Franking Credits

The discussion paper indicates there is a good argument that franking offsets can be streamed under the current tax laws (Subdivision 207-B ITAA 1997). However, in order to provide certainty about the streaming of franked distributions, the Government will amend Subdivision 207-B to modify the operation of Division 6 where a trustee receives a franked distribution with attached franking credits.

The Government proposes to amend the law to clarify the linkage between Subdivision 207-B and Division 6 to ensure there are no inconsistencies. This is to ensure that franked distributions, and their attached franking credits, are successfully streamed to the intended beneficiaries when the deed allows the trustee to identify separate classes of income and also to specify from what categories of income a beneficiary entitlement can be met.

Streaming of Capital Gains

The Government also believes the endorsement of the proportionate approach in Bamford means increased uncertainty as to the application of the current CGT provisions where capital gains are streamed to certain beneficiaries.

The Government is of the opinion that the legislative structure of the relevant provisions (namely Subdivision 115-C ITAA 1997) provides less guidance than those provisions relating to franked distributions.

Under the current law, at first glance, Subdivision 115-C may seem to provide a mechanism to allow streaming of capital gains. However, the provisions are problematic as they do not deal with the beneficiaries entitlement to the capital gains but rather the amount of the trusts capital gain that is included in the beneficiary's taxable income under section 97 ITAA 1997.

Under the proportionate approach the amount included in a beneficiary's assessable income under section 97 of the ITAA 1936 arguably consists of an un-dissected proportionate share of the trust's entire taxable income. This means the 'proportion of the taxable income' of the trust the beneficiary is taxed on may not align with the beneficiary's actual entitlement to capital gains and other income of the trust. That is, even though they may only be entitled to the capital gains of the trust, they are taxed on a mixture of all the types of taxable income of the trust.

On this view, a beneficiary may also be treated as having a capital gain under Subdivision 115-C even though they have no entitlement to the capital gains of the trust under the trusts deed.

The Government proposes to amend Subdivision 115-C to ensure the amount of a trust's taxable capital gain deemed to have been made by a beneficiary reflects that beneficiary's entitlement to the trust's gain for trust law purposes. For example, the amended rules will mean a beneficiary who is not entitled to share in a capital gain of the trust under the deed will not be taken to have an extra capital gain due to Subdivision 115-C. The amendments will also clarify the interaction between Subdivision 115-C and Division 6.

This proposed amendment would generally be of assistance for most trusts but there will be some trusts, like the MIT's referred to earlier, for which this change could be detrimental as it could result in the trustee being taxed at 46.5% on the capital gains without the benefit of any CGT discount.

Streaming Other Income

The discussion paper does not deal with the streaming of other types of income such as, foreign income, primary production income and Farm Management deposits. It is expected they will be dealt with in the final rewrite of the taxation of trust legislation when it is produced.

Submissions

The Government is asking for submissions to be lodged by 18 March 2011. If you have any comments that you would like to be included in a submission please contact your PKF office.

Should you require assistance or additional information, please contact your PKF Tax Adviser
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