THE LAW SOCIETY
OF NEW SOUTH WALES

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29 April 2011

Mr Haydn Daw
Manager
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Business Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email: **SBTR@treasury.gov.au**

Dear Mr Daw,

Exposure Draft – Taxing Trust Income

Thank you for the opportunity to comment on the exposure draft of the Tax Laws Amendment (2011 Measures No. 3) Bill 2011.

The Business Law Committee ('Committee') of the Law Society of New South Wales has considered the terms of the draft legislation. The Committee endorses the submission made by the Law Council of Australia dated 29 April 2011, a copy of which is enclosed.

Should you have any questions, please do not hesitate to contact Ms Lana Nadj, Policy Lawyer for the Business Law Committee, by phone on (02) 9926 0375 or by email to lana.nadj@lawsociety.com.au.

Yours sincerely

Stuart Westgarth
President

Law Council
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29 April 2011

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Via email: SBTR@treasury.gov.au

Dear Sir or Madam

The Taxation Commitee of the Business Law Section of the Law Council of Australia (**Committee**) welcomes the review into the taxation of trusts and is pleased to provide comments on the interim measures contained in the Exposure Draft – Improving the taxation of trusts (**ED**) and the Exposure Draft – Farm Management Deposits and Income Averaging (**FMD ED**), both released on 13 April 2011. This submission is supported by the Law Society of New South Wales.

Whilst the clarification of the ability to stream franked dividends and capital gains is a positive measure, particularly for the purposes of preparing tax returns for the current income year, the Committee considers it important that the proposed broader review of the taxation of trusts include measures to ensure that the recognition of the character of all income, gains and expenses through the trust structure to beneficiaries is consistently applied. The Committee also considers it important that the broad review of the taxation of trusts does eventuate, for a more thorough review of the core principles of present entitlement and the application of different income concepts to deliver a clearer and more equitable taxing regime for trusts.

Having regard to the short time frame within which the Exposure Draft and explanatory materials have been prepared and commented upon, the Committee also recommends that the final legislation be reviewed as part of a specific post-implementation consultation process early in the next tax year. Additionally, as a general comment, the explanatory material should be carefully reviewed and refined before being finalised, as it is currently overly complex and complicated and unlikely to provide sufficient benefit in terms of providing practical understanding of the new legislation for most practitioners and taxpayers.

The ED introduces rules specifically related to:

- streaming capital gains to beneficiaries;
- streaming franked dividends (and franking credits) to beneficiaries;
- specific anti-avoidance measures.

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The FMD ED introduces rules that enable trust beneficiaries to use income averaging and FMD provisions in a trust loss year. The rules reinstate the tax position that existed prior to the Full Federal Court's decision in *Federal Commissioner of Taxation v Bamford* (2010) 204 CLR 481 ***(Bamford)***.

Each of those new rules is addressed in detail below.

1. Capital Gains

We welcome the amendments which confirm that the taxation of net capital gains made by a trust should be assessed to the beneficiary under Subdivision 115-C of the *Income Tax Assessment Act* (Cth) *1997* (**ITAA 1997**). We consider that this is consistent with section 115-200 of the ITAA 1997 which provides as follows:

> *This Subdivision sets out rules for dealing with the net income of a trust that has a net capital gain.* ***The rules treat parts of the net income attributable to the trust's net capital gain as capital gains made by the beneficiary entitled to those parts****. This lets the beneficiary reduce those parts by any capital losses and unapplied net capital losses it has.*
>
> *If the trust's capital gain was reduced by either the general 50% discount in step 3 of the method statement in subsection 102-5(1) or by the small business 50% reduction in Subdivision 152-C (but not both), then the gain is doubled. The beneficiary can then apply its capital losses to the gain before applying the appropriate discount percentage (if any) or the small business 50% reduction.*
>
> *If the trust's capital gain was reduced by both the general 50% discount and the small business 50% reduction, then the gain is multiplied by 4. The beneficiary can then apply its capital losses to the gain before applying the appropriate discount percentage (if any) and the small business 50% reduction.*
>
> *The rules also give the beneficiary a deduction if necessary to prevent it from being taxed twice on the same parts of the trust's net income.*

Accordingly, where the trust income has been defined under the terms of the deed or determined by the trustee to include capital gains, it is not clear that the streaming measures proposed (necessarily) operate differently from the law as set out above. However, we welcome the additional clarity and certainty around the interaction of Division 6 (**Division 6**) of Part III of the *Income Tax Assessment Act* (Cth) *1936* (**ITAA 1936**) and the capital gains tax measures, including in circumstances where the trust income does not include capital gains.

We understand that the intention is to assess capital gains under the CGT provisions and not as part of Division 6 'net income' unless there is no beneficiary that is presently or specifically entitled to such gains. That is, the effect of section 115-225(5) of the ITAA 1997 is to allocate the capital gains to which beneficiaries are specifically and presently entitled, so that if there is any percentage of the income of the trust to which no beneficiary is presently entitled to then this amount will be assessed to the trustee under section 99A of the ITAA 1936 (please see our comments below).

The Explanatory Material should include an example of a tax equalisation clause where only net capital gains are included in trust income which we understand is a more common approach to tax equalise the income of the trust in 'family' trust scenarios.

The following additional issues should be clarified and enacted as part of the proposed streaming amendments:

(a) Whether the trustee is required to calculate and advise the beneficiaries of the trust of their Division 6 amount and/or percentage entitlement so as to determine the amount to be assessed under proposed Division 5B (**Division 5B**) of Part III of the ITAA 1936 in accordance with proposed section 94ZC of the ITAA 1936. Otherwise for any particular beneficiary may not be able to calculate this amount to be disclosed as part of that beneficiary's tax return. Where the trustee is required to advise the beneficiaries of these amounts then a beneficiary should be entitled to rely upon this notice or advice (absent actual knowledge to the contrary) to avoid an information void;

(b) Whether it is necessary to perform an 'equitable tracing' to establish that a beneficiary has a vested and indefeasible interest in the trust property that represents a capital gain for the purposes of proposed section 115-228 of the ITAA 1997, in circumstances where any of the following apply:

(i) there is a distribution of the proceeds from the gain; or

(ii) a resolution is passed before year end to distribute cash or trust property in specie; or

(iii) the terms of the trust are self executing and automatically allocate the trust's gains (or net capital gains where there is an income equalisation clause) to specific beneficiaries (including redeeming unitholders) provided the gain is made during the financial year and even where there is a realisation of trust property subsequent to a unitholder redeeming their units (that is, on the basis that the realisation will replace the liquid trust assets that were used to 'cash out' the redeeming unitholders. This is consistent with the comments of the full Federal Court in *Bamford.*)

(c) Proposed section 115-230 allows a trustee to elect to be taxed where there is a beneficiary that has specific entitlement to an amount which is not paid within 2 months of the financial close. However, in circumstances where capital gains are not part of the trust income then beneficiaries may continue to be taxed on amounts to which they have no entitlement. That is, a proportion of a capital gain to which no beneficiary is presently entitled is to be assessed to those beneficiaries consistent with their Division 6 proportionate share of the net income of the trust. We submit that a similar election should be available in these circumstances. That is, the trustee may elect to pay tax where the capital gains of the trust are not available to be distributed – either because there is no specific entitlement or because the present entitlement to income does not extend to the capital gains made by the trust (for example, because capital gains are not part of the income of the trust).

(d) Where there are a number of capital gains and losses made by the trustee during the year, will the trustee need to 'allocate' individual gains before year end to satisfy the specific and present entitlement requirements? We submit that the calculation of the net gains for the financial year should be made after year end notwithstanding that such entitlement may be established before year end through appropriate trustee resolutions and trust deed provisions.

(e) Whether the intended operation of proposed section 115-225(2)(b) of the ITAA 1997 is to allocate the expenses incurred by the trustee against capital gains and franked dividends as a priority in determining the attributable gains of the trust. We understand that this is required to ensure that the adjustment to be made under proposed section 94ZC of the ITAA 1936 can not result in a Division 6 amount being a loss (that is, where the net capital gains and franked dividend income amounts exceed the net income of the trust). This raises loss quarantining issues. In these circumstances, the Division 5B adjustment should not exceed the Division 6 amount that is assessed to the beneficiary. However, we note that the effect of this priority allocation is to reduce the (potentially concessionally taxed) capital gains of the trust rather than revenue profits of the trust because the calculation of net capital gains is expressly determined under Part 3, we suggest that a notional deduction mechanism (that is, against Division 6 income) provides a more equitable outcome.

(f) Confirmation that where a non-resident beneficiary of an Australian trust is presently and specifically entitled to a capital gain that does not arise in respect of taxable Australian property then the gain is not taxable to either the trustee or the beneficiary. That is, section 855-40 of the ITAA 1997 will continue to apply and no amount will be assessed to a trustee because there is no amount of capital gains included as part of Division 6 net income.

(g) The construction of *vested and indefeasible interest* in trust property representing the capital gain in proposed section 115-228 of the ITAA 1997 is ambiguous. That ambiguity becomes apparent in circumstances where, for example, a trustee has made a capital gain on the disposal of an asset to which the market value substitution rule applies, with the result that the *capital gain made by the trust (say $1 million) exceeds the actual capital proceeds to which a beneficiary has a vested and indefeasible interest (say $100,000). For the purposes of calculating the beneficiary's *share* of the capital gain under proposed section 115-225(4) of the ITAA 1997, is the beneficiary *specifically entitled* to $1 million or to $100,000? We can identify revenue collection and policy issues with either construction or approach and accordingly suggest that this requires further consideration and clarification.

- If it is $1 million - the tax burden passes to the beneficiary who is entitled to the benefit of the actual capital proceeds, but the liability will exceed this amount. (The trustee however may elect to be assessed under either section 99 or section 99A of the ITAA 1936 under proposed section 115-230 of the ITAA 1997, if the requirements of that section are satisfied). There may be collection problems where neither the capital beneficiary nor the trustee have the funds to pay the tax. From a policy perspective this outcome may be inconsistent with a quantum approach but it appears consistent with the policy objective of taxing the beneficiary that is entitled to the capital gain/proceeds (unless the trustee elects otherwise).

- If it is only the capital proceeds ($100,000) and there are income beneficiaries - the income beneficiaries will be assessed on the $900,000 in accordance with their proportionate entitlements under Division 6. There is no election available to the trustee to relieve the income beneficiaries of this burden. Are the income beneficiaries the appropriate taxpayer in this instance?

It also leaves open the question of whether there are any particular capital gains tax events for which there cannot inherently be a specific or present entitlement.

(h) The notes which accompanied the ED refer to an amount needing to be only "earmarked" to identify a beneficiary as being *specifically entitled* to a capital gain. In the case of franked distributions, all that is required is that the distribution have been "specifically allocated". In the case of capital gains, a *vested and indefeasible interest* is required, which is a much more demanding nexus. Treasury will no doubt be aware of the practical difficulties in establishing as a matter of law that a beneficiary has a *vested and indefeasible interest* in the income or property of the trust in this scenario (please see our comments above).

(i) It is proposed that in addition to having a *vested and indefeasible interest* in trust property, for a beneficiary to be *specifically entitled* to a capital gain, that interest in trust property must be *recorded in the accounts*. Is this intended to introduce a requirement that entitlements to trust income or trust property must always be recorded in the trust accounting records? We suggest that this may result in a default to accounting notions of profit and should be considered as part of the wider trust review and not as an interim measure. This further requirement is unnecessary because the accounts can only record something which has occurred and should be deleted. However, where a beneficiary has been paid their entitlement out of trust property then generally the beneficiary's account in the financial statements or account of the trust or the trust's records would reflect this entitlement (this would be recorded in the accounting records or the financial statements).

(j) Proposed section 115-230(3)(b) of the ITAA 1997 applies where (*inter alia*), a beneficiary of the trust is "specifically entitled to all or any part of the capital gain". A beneficiary may be subject to tax on part of a capital gain to which the beneficiary is not "specifically entitled" by virtue of the Division 6 percentage allocation in proposed section 115-225(5)(b) of the ITAA 1997. It is submitted that the trustee should be able to elect to be taxed on that type of capital gain. As a policy matter, it would appear even more important to liberate a beneficiary from tax on gains to which they are not specifically entitled than ones to which they are.

(k) By way of general comment we submit that there is a need for there to be greater clarity as to:

   (i) the consequences of an accumulation of a capital gain by the trustee;

   (ii) the latest time by which a beneficiary must become *specifically entitled* to a capital gain for proposed section 115-228 of the ITAA 1997 to operate;

   (iii) the fact that the *trust property representing the capital gain* in which a beneficiary must have a *vested and indefeasible interest* for the purposes of proposed section 115-228 of the ITAA 1997 is **not** limited to the trust property which gives rise to the capital gain. In many cases, that property will be disposed of to a third party so that the *trust property* for the purposes of that section may include a *vested and indefeasible interest* of a beneficiary to trust property of all descriptions, including cash derived from the receipt of the proceeds of the capital gain; and

   (iv) the mechanism for the deduction of *directly relevant expenses* from attributable capital gains (see the "third step" on page 2 of the Advanced Summary notes which preceded the Explanatory Memorandum). Proposed section 94ZA(b)(ii) of the ITAA 1936 refers expressly to the deduction of *directly relevant expenses* from franked distributions, but the treatment of *directly relevant expenses* for attributable capital gains is unclear.

(l) Section 118-20(1) of the ITAA 1997 will need to be amended so it works properly once capital gains are taxed to beneficiaries under proposed amendments to Subdivision 115-C of the ITAA 1997. Section 118-20(1) is the provision which aims to prevent double taxation of the same gain under both the capital gains tax and other income tax provisions. The section provides:

"(1) A capital gain you make from a CGT event is reduced if, because of the event, a provision of this Act **(outside of this Part)** includes an amount (for any income year) in:

(a) your assessable income or exempt income;" [Emphasis added]

This provision will no longer work under the proposed scheme where the taxation of capital gains made by a trust is removed from section 97 of the ITAA 1997 and instead dealt with under the proposed amendments to Subdivision 115-C of the ITAA 1997. This is because Subdivision 115-C of the ITAA 1997 is in the same "Part" as section 118-20(1) of the ITAA 1997, namely Part 3-1 of the ITAA 1997.

An example of how the current wording of section 118-20(1) of the ITAA 1997 will not work with the proposed amendments is where a trustee of a testamentary trust transfers a trust asset to a life tenant to end the life interest. CGT event E6 will be triggered by such an action and both the trustee and the life tenant may derive a taxable capital gain. Under the current law, section 118-20(1) of the ITAA 1997 will prevent double taxation of the gain where the life tenant is taxed on the capital gain made by the trustee under CGT event E6 under section 97 of the ITAA 1936: see TR 2006/14 at paragraphs 82-84.

Section 118-20(1) should be amended as follows:

"(1) A capital gain you make from a CGT event is reduced if, because of the event, a provision of this Act (outside this Part or under subsection 115-215(3), section 115-220 and section 115-222) includes an amount (for any income year) ..."

2. Franked dividends

2.1 Uncertain link to beneficiary's assessable income

It is not clear from the draft legislation exactly how franked dividends which are included in the net income of a trust should be included in the assessable income of a beneficiary.

Proposed section 94ZC of the ITAA 1936 purports to operate so that when one is working out the amount to be included in a beneficiary's assessable income under section 97 of the ITAA 1936 it is to be assumed that the net income of the trust is equal to the "Division 5B net income of the trust estate": proposed subsection 94ZC(3) of the ITAA 1936.

The "Division 5B net income of the trust estate" is defined as the net income of the trust upon the premises, *inter alia*, that neither the franked distribution nor the franking credit is taken into account in working out that net income: proposed subsection 94ZB(3) of the ITAA 1936.

Page 1 of the Advanced Summary of the Explanatory Material ("**Advance Summary**"), which accompanied the exposure draft legislation and paragraph 1.79 of the draft explanatory memorandum (**Draft EM**), indicate that the intention of proposed section 94ZC of the ITAA 1936 is to remove the taxation of franked distributions from Division 6 and deal with it under Subdivision 207-B of the ITAA 1997.

When one tracks through Subdivision 207-B of the ITAA 1997 (as amended by the exposure draft legislation) it appears that the charging provision in proposed subsection 207-35(4) of the ITAA 1997 (which operates to include franked dividend income of a trust and its related gross up in a beneficiary's assessable income) may not efficiently operate.

There is a defect in proposed subsection 207-35(3) of the ITAA 1997 which provides:

> "(3) Subsection (4) applies if:
>
> (a) a *franked distribution is made, or *flows indirectly, to a partnership or the trustee of a trust in an income year; and
>
> (b) the assessable income of the partnership or trust for that year includes an amount (the ***franking credit amount***) that is all or a part of the additional amount of assessable income included under subsection (1) in relation to the distribution; and
>
> (c) the distribution flows indirectly to an entity that is a partner in the partnership, or a beneficiary or the trustee of the trust; and
>
> (d) *the entity has an amount of assessable income for that year that is attributable to all or a part of the distribution.* " [Emphasis added.]

The default arises because paragraph (d) of proposed subsection 207-35(3) of the ITAA 1997 requires that the "entity" (which from paragraph (c) is, *inter alia*, the beneficiary) must have an amount of assessable income for that year that is attributable to all or part of the franked distribution. However, since proposed section 94ZC of the ITAA 1936 carves out franked dividends and the franking credit from the net income that a beneficiary is presently entitled to under section 97 of the ITAA 1936, the beneficiary's assessable income from the trust may not include any part of the franked distribution. A failure to meet paragraph (d) means that proposed subsection 207-35(4) of the ITAA 1997 can not operate to include the beneficiary's share of the franked distribution and franking credit in the beneficiary's assessable income.

To resolve this issue we recommend that proposed subsection 207-35(3)(d) of the ITAA 1997 be amended as follows:

> "(d) the entity would have ~~has~~ an amount of assessable income for that year that is directly or indirectly attributable to all or a part of the franked distribution if Division 5B of Part III of the *Income Tax Assessment Act 1936* is ~~was~~ disregarded."

Paragraph 1.63 of the Draft EM indicates that the final legislation will incorporate a provision along the lines of the proposed section 115-225 of the ITAA 1997 to ensure that the provisions only operate on the amount of franked distribution that is included in taxable income of the trust after applying directly relevant expenses. This additional provision does not appear to solve the defect discussed above.

2.2 Continuation of an explanatory example

Proposed subsection 207-35(3) of the ITAA 1997 does not contain an explanatory example of how the gross up and franking credit flows through to trust beneficiaries. In contrast, the current subsection 207-35(3) of the ITAA 1997 does provide such explanatory guidance. There should be an explanatory example based on the amended law in proposed subsection 207-35(3) of the ITAA 1997 so as to provide guidance to taxpayers.

2.3 "Directly Relevant Expense"

Proposed subsection 94ZA(b)(ii) refers to a net franked distribution remaining after "expenses incurred that were directly relevant to" the franked distribution are subtracted.

We suggest that the final explanatory memorandum should provide more guidance on what expenses would be considered to be "directly relevant" to a franked distribution. For instance, consider the circumstance where a trust has a prior year loss which is solely attributable to interest expense deductions related to a borrowing taken out by the trustee to acquire the shares on which the franked distributions are received. Would such a prior year loss be considered to be a directly relevant expense in a later income year when it is recouped? Additionally, what is the situation where a trust's prior year loss comprises a mix of expenses including expenses directly related to the derivation of franked dividend income? Is there a requirement for some apportionment of the loss and only that amount referable to the franked dividends, then applied against franked distributions in the current income year?

2.4 Information asymmetry issues

The amount of information required to apply these new trust provisions is extensive – particularly in working out a beneficiary's Division 6 percentage entitlement and working out the rateable reduction where the sum of a trust's net capital gain and net franked distributions exceeds the taxable income of the trust. A beneficiary may not have access to such information especially where the trust is a widely held structure. Accordingly as highlighted above in the discussion relating to the streaming of capital gains, consideration should be had to whether the trustee is required to calculate and advise beneficiaries of their Division 6 percentage entitlement and the amount that will be assessed to them under proposed Division 5B of Part III of the ITAA 1936.

2.5 Errors in draft Explanatory Memorandum

The last paragraph of Example 1.7 on page 19 of the Explanatory Memorandum appears to have a mistake. We suggest that the sentence should read as follows:

> Subdivision 207-B operates to include in Sharon's assessable income $75 (calculated as $52.50 plus $~~17.50~~22.50) and in Audrey's assessable income $25 (calculated as $17.50 plus $7.50).

There also appears to be a problem with Example 1.8. At the beginning of the example we are told that the trust deed equates trust income with section 95 net income; however, later in the example it is suggested that the trustee purports to accumulate that part of a capital gain which is sheltered by the CGT discount (i.e. $100). This statement appears wrong because trust income does not include this amount since it is equal to section 95 net income which does not include the CGT discount amount. There does not appear to be any active "accumulation" on the trustee's part at all in this example.

2.6 Uncertainty where relevant direct expenses exceed franked dividend income but net income of the trust still positive

The Advance Summary indicates that the Government will continue its policy that no franking credits can be claimed where a trust has no positive net income. However, the situation is not so clear where there is positive net income but direct expenses related to dividend income exceed such dividend income. This position should be clarified. Consider the following example:

A trust derives a fully franked dividend of $70 and incurs an $110 interest expense directly related to the dividend income.

The trust also derives $100 rent income.

The notional net taxable income of the trust is $90 (consisting wholly of the rent income).

How does one allocate the franked dividend income to a beneficiary in this situation?

Under the current law it is possible to pass through franking credits so long as the trust has at least $1 positive net income.

It appears, however, from the discussion in paragraph 1.63 of the Draft EM that a beneficiary's assessable income will include their share of the franked distribution to the extent that it is included in the taxable income of the trust. The italic wording in that paragraph further provides that the final version of the legislation will incorporate a provision along the lines of proposed section 115-225 of the ITAA 1997 to ensure that the franking credit provisions only operate on the amount of a franked distribution that is included in the taxable income of the trust after applying directly relevant expenses. One reading of this paragraph could be that the aim is to ensure a beneficiary is not taxed on more of a franked distribution than is included in the trust's net income, which is an appropriate result.

However, paragraph 1.63 of the Draft EM also suggests in the above numerical example that franking credits would be lost because none of the taxable income of the trust represents an amount of the franked dividend income (interest expenses having wholly offset the dividend income). Therefore a beneficiary would not have a share of the franked distribution and would not be entitled to franking credits since the franking credit entitlement in existing section 207-57 of the ITAA 1997 (which is not being amended by these trust taxation proposals) runs off an entity's share of the franked distribution.

It is not clear why this new adverse policy position should be taken against trusts when companies in the same position can continue to benefit from franking credits. It is recommended that this new position not be pursued and that trusts should continue to be able to confer franking credits on beneficiaries so long there is positive net income. The new trust taxation provisions should be amended so that in the situation outlined above the trustee can still allocate the benefit of franking credits to beneficiaries who receive a portion of the trust income.

3. Specific anti-avoidance provision

3.1 Rationale

The rationale for the anti-avoidance provision contained in proposed section 100AA of the ITAA 1936 should be considered having regard to the following points:

(a) capital gains and franked distributions are to be included in the assessable income of beneficiaries under the quantum approach in accordance with amendments to be made to Division 115-C and 207-B of the ITAA 1997 respectively (but any amounts to which beneficiaries are not specifically entitled are to be included in their assessable incomes proportionately[1]). Consequently:

    (i) subject to proposed section115-225(2)(b) capital gains will be assessable to beneficiaries (or the trustee) even if the trust estate has a loss under the current regime. It is unclear how these provisions will operate where the trust has carried forward tax losses which are required to be met out of corpus but the beneficiary entitled to the capital gain has no interest in the corpus because in the case of such beneficiaries these losses are excluded from the calculation of net income in section 95[2];

    (ii) where the only beneficiary specifically and presently entitled to the capital gain is an exempt entity, the scope for avoidance to which the

[1] See proposed section 207-55(4)(b) and 115-225(5)(b)

[2] Which also raises the application of the rule in *Upton v Brown* which was considered by the High Court in *Raftland* at pp540-542

Commissioner adverted in his application for special leave in *Cajkusic & Ors v FCT* 2006 ATC 4752 will remain; and

(iii) it appears that other anti-avoidance provisions in Division 6 such as proposed section 100A of the ITAA 1936 will not apply to arrangements involving capital gains or franked distributions.

(b) otherwise, (excluding the proposed anti-avoidance provisions in proposed section 100AA of the ITAA 1936), the operation of Division 6 is not affected. In particular the amount to be included in the assessable income of a beneficiary under section 97 of the ITAA 1936 is to be determined in accordance with the principles set out in *Bamford* namely that "share" is to be determined on a proportionate basis and "income" is that which is income in accordance with general trust principles. Hence the proposed amendments address some of the issues which the Commissioner identified as remaining uncertain in his Decision Impact Statement.

(c) Proposed section 100AA of the ITAA 1936 deals only with cases in which exempt entities would otherwise be presently entitled to all or part of the income of a trust. These are defined in section 995 of the ITAA 1997, broadly stated, as entities whose ordinary and statutory income is exempt from tax. However the Summary of Intended Outcomes refers in addition to low tax entities. The Commissioner needs to clarify the ATO position.

3.2 Structure

There are two regimes:

(a) the first is where the trustee does not give the exempt entity notice in writing of its present entitlement two months before the end of the relevant income year; and

(b) the second is where the trustee does give such notice.

3.3 No Notice

If the requisite notice is not given the exempt entity is treated as not being presently entitled to the income save to the extent to which it has been paid that amount within two months of the end of the year of income.

If this regime is intended to address sham arrangements it is pointless because the exempt entity will not become presently entitled to the income[3]. If this is not so, the putative avoidance is adequately dealt with by pertinent provisions in the second regime (where notice is given).

This is a harsh regime which may operate inequitably because the net income which would otherwise have been included in the assessable income of the exempt entity will be included in the assessable income of the beneficiaries; or assessed to the trustee[4] even though they will not be presently entitled to the corresponding income. We submit that proposed section 100AA(2) of the ITAA 1936 ought not to apply if the Commissioner is of the opinion that it would be unreasonable to do so (as in the case of the second regime).

It is unclear whether the notice is to specify the amount of the present entitlement or merely the fact of the present entitlement. If the former, the period of two months should be extended to the lodgement of the trust's income tax return so as to enable the amount to be quantified.

[3] *Raftland Pty. Ltd. v Commissioner of Taxation* (2008) 238 CLR 516
[4] The uncertain effect of the subsection is discussed in section 3.4 below

3.4 Notice

Proposed section 100AA(4) of the ITAA 1936 equates the exempt entity's present entitlement to its benchmark percentage determined under proposed section 100AA(5) of the ITAA 1936. Proposed section 100AA(5) of the ITAA 1936 requires a proportionate calculation based on the trust's adjusted net income. The trust's adjusted net income is defined in proposed section 100AA(6) of the ITAA 1936 as being its net income reduced by amounts that do not represent net accretions of value to the trust estate.

The apparent intended effect of proposed sections 100AA(5) and 100AA(6) of the ITAA 1936 is to limit an exempt entity's present entitlement to its proportionate share of that part of the Division 5B income which reflects accretions to the trust estate.

It operates successfully where the difference is because the trust income takes into account amounts utilised in calculating its net income (ie under general trust principles or particular provisions in the deed) or because the trust income does not include particular receipts or amounts which are utilised in calculating the trust's net income. In such cases the Division 6 percentage will be less than the benchmark percentage. However, these provisions are not properly integrated with Division 6 or the proposed amendments to Sub-division 115 C of the ITAA 1997.

Firstly, proposed sections 100AA(5) and (6) of the ITAA 1936 may not be effective where the exempt entity became presently entitled to the income as a consequence of the exercise of the trustee's discretion in its favour. In such cases section 101 of the ITAA 1936 deems the beneficiary to be presently entitled to the amount paid to him or applied for his benefit thereby engaging section 97 of the ITAA 1936. There should therefore be a provision to the same effect as section 100A(2) of the ITAA 1936 which deems such amounts not to have been paid or applied (*Idlecroft Pty Ltd v Federal Commissioner of Taxation*[5]).

Secondly, the amounts being excluded from the adjusted net income will include capital gains calculated by reference to the market value substitution rules and it is unclear whether these are to be excluded by the assumptions made under proposed section 94ZC of the ITAA 1936, which are dealt with under proposed Divisions 207-B and 115-C of the ITAA 1997. However, capital gains to which no beneficiaries are specifically entitled are to be assessed to beneficiaries in accordance with their present entitlements to income under proposed section 115-225(4) of the ITAA 1997. Hence, all or part of such capital gains will still be included in the assessable income of exempt beneficiaries even though they do not reflect accretions to the trust estate.

In addition, although a trust's adjusted net income will exclude amounts otherwise included in the net income because of the operation of various other anti-avoidance provisions such as Part IVA of the ITAA 1936, transfer pricing adjustments and controlled foreign corporation provisions, the proposed amendments may operate inequitably or be ineffective.

They may operate inequitably because such amounts will be assessed to the beneficiaries who are presently entitled to the Division 5B income and otherwise be assessed to the trustee. This results in a potential (further) inequity between beneficiaries because the amounts to be included in the assessable incomes of those entitled to capital gains or franked distributions will be less than what they otherwise would have been.

They may not be effective if the exempt entity is presently entitled to an amount equal to all the adjusted net income because its bench mark percentage will be the same as its Division 6 percentage so that there is no reduction in its present entitlement. If, for

[5] (2005) 144 FCR 501, 507

example, the net income comprises interest of $100 (to which the exempt entity is presently entitled) and there is a transfer pricing adjustment of $1000, the adjusted net income would be $100 and the exempt entity's Division 6 percentage also would be $100. Hence the whole of the trust's net income would be included in its assessable income and section 100AA will be nullified.

4. FMD & Income Averaging Rules

The Committee supports the proposed amendments to the FMD and the Income Averaging rules contained in the FMD ED. However, the Committee considers that limiting a trustee's ability to appoint chosen beneficiaries to four or less for an income year should be removed, in the absence of any specific concerns.

Conclusion

The Committee would appreciate the opportunity to engage in continued discussion about these proposed changes and the broader review relating to the taxation of trusts. If you would like to discuss this submission, or any potential future involvement of the Committee in this review, please contact the Committee Chair, Ms Teresa Dyson on teresa.dyson@blakedawson.com or 07 3259 7369.

Yours faithfully

Bill Grant
Secretary-General