

Trust distributions: the Commissioner speaks...

PS LA 2009/7 is the latest development in the ongoing saga of the proper treatment of trust net income. This article traverses some of the significant issues raised by the Practice Statement and their implications for the preparation of trust distribution minutes. Clearly, advisers need to exercise a high degree of diligence in this area

On 20 August 2009 the Commissioner of Taxation released Practice Statement PS LA 2009/7 (**Practice Statement**). The Practice Statement has been released pending the outcome of the *Bamford* litigation – with both the taxpayer and the Commissioner having sought special leave to appeal to the High Court on the Full Federal Court decision.¹

At one level, the Practice Statement may be viewed as providing some comfort to taxpayers. ATO staff are only to apply the views of the Commissioner in *Bamford* if there is a deliberate attempt to exploit Div 6 of Part III of the *Income Tax Assessment Act 1936* or, alternatively, if there is dispute as to the net income of a trust. However, these principles are highly subjective and are likely to be difficult to apply in practice. Moreover, the examples in the Practice Statement do not clarify many of the mainstream issues confronted by trustees and their advisers in preparing trust distribution minutes.

Of even greater concern is the broader issue of the Commissioner's decision to administer the law in a manner that is contrary to judicial interpretation. In the authors' view, the decisions of our courts should not be taken lightly and it is dangerous territory for the Commissioner to pick and choose which decisions (or parts of decisions) bind him and which do not.

All statutory references in this article are to the *Income Tax Assessment Act 1936* unless otherwise indicated.

CONTEXT OF PRACTICE STATEMENT

Commissioner's views in *Bamford*

In the specific circumstances outlined in the Practice Statement, the Commissioner seeks to administer the tax law in a manner that is inconsistent with binding legal authority. The Commissioner justifies this approach to tax administration on the basis that the Full Federal Court decision in *Bamford* is wrong and is in the process of being challenged.² At the time of writing this article, the High Court has not yet heard the parties on their respective applications for special leave. The Practice Statement is premised on the Commissioner succeeding in his special leave application.

It is not the purpose of this paper to review the Full Court decision in *Bamford*. That decision has been examined in detail elsewhere.³ However, in order to understand the Practice Statement, it is necessary to briefly revisit the views adopted by the Commissioner on the two hotly contested issues.

The Commissioner's position in *Bamford* may be summarised as follows:

- First, that the phrase "income of a trust estate" in s 97(1) and elsewhere in Div 6 is a reference to income according to ordinary concepts. The phrase does not, as the taxpayer has been contending in *Bamford*, depend on the trust deed or resolutions effected pursuant to the trust deed. In the Practice Statement, this is referred

to as the Commissioner's view of income of a trust estate.

- Second, a strict arithmetic methodology is required in applying the proportionate approach for the allocation of excess s 95 net income (see further below). This is based on a literal interpretation of the term "share" in s 97(1) and is accordingly referred to in the Practice Statement as the Commissioner's view of share.

The Commissioner was unsuccessful in the Full Federal Court on the meaning of income of a trust estate but was successful in arguing his view of share. The taxpayer is seeking special leave to challenge the Commissioner's view of share – so that issue is still contentious.

Significance of Issues

Although the issues considered in *Bamford* are discrete, they are interrelated. Both issues turn on how the tax law should deal with a trust estate's excess s 95 net income. This situation arises where the net income for a particular income year as defined by s 95 (**tax net income**), exceeds the income of a trust estate for that year. For brevity, we have sometimes referred to the income of a trust estate as the **trust income**. This is the amount legally available to the trustee for distribution to the beneficiaries.⁴

As the assessing provisions of Div 6 make clear (and decades of case law have reinforced), a beneficiary's assessment to the tax net income of a trust estate depends on that beneficiary's present entitlement to a share of the trust income. So where the tax net income exceeds the trust income, it is necessary to determine precisely how that excess tax net income is to be assessed.

In practice, some of the more common situations where the tax net income may exceed the trust income include where:

- expenses are incurred for accounting purposes but are not deductible for tax purposes;
- expenses are incurred in a particular income year but are not deductible until a later income year or years eg certain prepayments;⁵
- accounting depreciation on an item of plant occurs at a faster rate than the applicable capital allowance deductions for the same depreciating asset;
- profit made from certain transactions is assessable under the tax legislation but would not be regarded as income of a trust estate eg balancing adjustments on the disposal of depreciating assets, net capital gains or disposals of trading stock outside of the ordinary course of business;
- accounting losses are required to be carried forward and offset against future accounting income but there is no corresponding carry forward tax losses;
- amended assessments are raised that deny deductions or include additional assessable income in the calculation of the trust's tax net income on the basis that the original assessment has been incorrectly returned.⁶

In these excess tax net income situations, the Commissioner contends (and the Full Federal Court agrees) that a proportionate approach is to be adopted. This involves any excess tax net income being allocated to beneficiaries in the same proportions or percentages to which the beneficiaries were presently entitled to the trust income. The taxpayer in *Bamford* did not dispute the proportionate approach altogether but argued that its application needs to be applied in the context of the particular resolutions. The taxpayer argued that the trustee may exercise its power of appointment to limit the amounts of any excess tax net income to particular beneficiaries or may apply any excess tax net income to beneficiaries who are intended to receive the balance of trust income.⁷ The Commissioner's view of share, however, means that the words of a trustee distribution minute are irrelevant provided

they create a present entitlement to trust income in the beneficiaries. It is only necessary to determine how much of the trust income a particular beneficiary is presently entitled to and that will provide the basis for determining that beneficiary's proportionate share of the excess tax net income.⁸

The Commissioner's view of income of a trust estate means that the problems of having no trust income (and being potentially subject to a s 99A assessment) or having excess tax net income, cannot be remedied by the provisions of the trust deed. Therefore, a trust deed that defines the trust income to be the tax net income is ineffective in dealing with excess tax net income scenarios. Clauses that attempt to give the trustee a power to treat capital receipts as income and vice versa are likewise ineffective.

The Commissioner's view of income of a trust estate upsets the long standing practice of relying on the provisions of a trust deed to define the trust income or re-characterise the trust income for the purpose of making effective trust distributions. Clearly, this issue has wide ranging implications. If the Commissioner is correct, it would be impossible for a beneficiary to ever be assessed on amounts that are not income according to ordinary concepts where there is no trust income for the particular year in question.

THE COMMISSIONER SPEAKS...

Outline of PS LA 2009/7

Having considered the Commissioner's views in *Bamford*, it is timely to turn to the Practice Statement itself. From the outset, it is important to bear in mind that the Practice Statement is not a public ruling. It is a direction from the Commissioner to ATO staff on how to administer the tax laws for compliance activities, assessments, rulings, objections and appeals. Even though the Practice Statement is intended to be followed by ATO staff, the Practice Statement says staff may depart from its principles where they form a view that doing so would create unintended consequences or would otherwise be incorrect.⁹ At best, the Practice Statement is a broad indication of how the ATO may administer the law – nothing more.

The general principles outlined in the Practice Statement may be summarised as follows:

- Any assessments raised as a result of compliance work specifically outlined in the Practice Statement will be based on the Commissioner's views of income of a trust estate and share. This includes situations where there has been a deliberate attempt to avoid Div 6 through a mismatch of a beneficiary's entitlements and the tax outcomes;¹⁰
- In addition, if there is any dispute about the tax net income or who should be assessed on the tax net income, the Commissioner may raise assessments in accordance with his views on income of a trust estate and share;¹¹
- ATO staff should not seek active compliance solely with a view to applying the Commissioner's views unless there has been a deliberate attempt to exploit Div 6 or there is a dispute as to a trust's tax net income;¹²
- Provided there is no tax avoidance, a taxpayer who has relied on the decision of the Full Federal Court in *Bamford* will not be subject to penalties on assessments and may be eligible for a remission of interest;¹³
- ATO officers should seek agreement of taxpayers to defer determinations on rulings, objections or appeals pending the outcome of a decision in *Bamford*;¹⁴
- In relation to disputes about tax net income, ATO staff may raise alternative assessments to take account of the potential outcomes of the *Bamford* litigation;¹⁵
- PS LA 2005/1 (GA) (Taxation of Capital Gains of a Trust) can still be relied upon for now by taxpayers who are self assessing but despite this, the Commissioner will apply his views in PS LA 2009/7 if a dispute arises.¹⁶

It is the first three of these principles that are likely to be of most significance to trust taxpayers and their advisers and we have therefore reviewed these principles further below.

Deliberate attempts to exploit Division 6

The Commissioner gives the following example as a deliberate attempt to avoid Div 6:

“ Decisions of courts should not be taken lightly. It is dangerous territory for the Commissioner to pick and choose which decisions bind him and which do not. ”

Example 1

13. In a particular year the trustee of a family trust derives \$250,000 of ordinary income of which \$245,000 is applied to acquire a holiday home for the family. The trust deed provides the trustee with a power to appoint income and capital amongst a single class of discretionary objects. It also confers a broad power to characterise receipts and outgoings as on income or capital account.
14. In the relevant year one of the discretionary objects is in a loss position for tax purposes.
15. The trustee, in purported exercise of its power under the deed, determines that the purchase of the holiday home involved an outgoing on income account and that consequently the income of the trust legally available for distribution for the year is \$5,000. The trustee further resolves that this amount is to be appointed to the loss beneficiary. The trustee contends that as the loss beneficiary is presently entitled to all of the income of the trust for section 97 purposes, so all of the net income of the trust is assessable to the loss beneficiary. This would have the result that the net income of the trust would not be subject to tax.

This is a curious example. The same tax result could have been achieved, not by re-characterising the outgoing as on income account, but by simply distributing the \$250,000 of ordinary income to the loss beneficiary. The loss beneficiary (assuming it was not a private company for Div 7A purposes – and the example makes no mention of this) could then have lent the amount back to the trustee of the trust for acquisition of the holiday home. The same tax outcome could therefore have been achieved without relying on the highly unusual approach of re-characterising the outgoing to purchase the holiday

home as income in nature. The example is an unhelpful start to elucidating the principles trust taxpayers can rely upon in determining whether or not they will be subject to any ATO exposure.

The test the Commissioner seeks to adopt in the above and other examples in the Practice Statement is that a deliberate attempt to exploit Div 6 arises where there is a mismatch between a beneficiary's entitlements and the tax outcome. The Commissioner provides the following as an example of a situation where no such mismatch arises:

Example 2

17. In a particular year the trustee of a family trust does not derive any ordinary income but makes a net capital gain of \$100,000. The trust deed provides the trustee with the power to appoint income and capital amongst a single class of discretionary objects. It also confers a broad power to characterise receipts and outgoings as on income or capital account.
18. In the relevant year, one of the discretionary objects is in a loss position for tax purposes.
19. The trustee, in purported exercise of its power under the deed, determines that the income of the trust legally available for distribution for the year is \$100,000 and the amount is to be appointed to the loss beneficiary. The amount of \$100,000 is subsequently distributed to the loss beneficiary.
20. The trustee takes the view that the section 95 net income of the trust (that is, the net capital gain) should be included in the assessable income of the loss beneficiary. This would result in the amount being offset by the beneficiary's prior year tax losses.

The above example may be comforting to trust taxpayers in that the act of distributing a net capital gain to a loss beneficiary in circumstances where the trust has no trust income is a fairly typical situation that arises in practice. Without inclusion of this example in the Practice

Statement, distributions of net capital gains to loss beneficiaries in this situation may have been considered “up for grabs” by the Commissioner on audit.

It should be noted that in the above example, the arrangement is effective because the trust deed contained a provision for the trustee to characterise the \$100,000 capital gain as trust income. In the absence of such a provision in the trust deed (or a provision aligning the trust income with tax net income) and reliance on those provisions in drafting the trustee distribution minutes, the loss beneficiary is unlikely to be treated as being presently entitled to the net capital gain.

It is disconcerting to think that if the Commissioner is ultimately proved right by a High Court decision in *Bamford*, the above sensible result would not arise. In effect, because a net capital gain could never be treated as income according to ordinary concepts (by nature, income and capital are mutually exclusive concepts) then all net capital gains derived by trusts with no trust income would need to be assessed to trustees. One might expect this result would require legislative intervention. Without legislative intervention, the tax outcome would potentially sound the death knell for many trusts as tax effective vehicles.

There are but two examples in the Practice Statement where the Commissioner contends that there is a deliberate attempt to avoid Div 6 through a mismatch of beneficiary entitlements and tax outcomes. The first has been addressed in example 1 above. The second example is as follows:

Example 5

30. In a particular year the trustee of a family trust derives \$100,000 of income. The trust deed has two classes of beneficiaries – those entitled to share in income and those entitled to share in the capital – and the membership of these two classes is different. The trustee has the power to appoint income and capital within the two classes of beneficiaries respectively. The deed also confers on the trustee a power to determine whether the receipts and outgoings are on income or capital account.
31. Having received advice on effective strategies for minimising tax, and in accordance with the terms of that advice:

- the trustee, in purported exercise of a power under the deed, amended the deed to admit into the class of income objects of a trust a tax exempt charity; and
- the trustee determined to characterise \$95,000 of the income as a capital receipt for the purposes of the deed.

32. The trustee appoints the \$5,000 of income to the charity and the remaining \$95,000 is appointed, as capital, to a family member who is an eligible capital beneficiary. The trustee contends that as the charity is presently entitled to all of the income of the trust for s 97 purposes, so all of the net income of the trust is to be attributed to the charity. This would result in the net income of the trust being free of tax.

33. Prior to the year in question, the only entities to have benefited from a distribution of income from the trust were members of the family for whom the trust was settled.

34. The facts of this example are such as to raise the potential application of Part IVA. The Commissioner would select an arrangement of this kind for active compliance and would apply his view of income of the trust estate and, in the alternative, Part IVA.

One may question whether the trust deed and its ability to redefine trust income is the real mischief here. The ability to treat income receipts as capital and vice versa is only part of the scheme that results in a tax benefit being achieved in this example. A power of this kind can be used in situations which are clearly less offensive to the revenue. In fact, the Commissioner has recognised the legitimate use of this power in Example 2 of the Practice Statement (cited above).

In the authors' view, the scheme outlined in Example 5 above is the kind of situation that ought to be subject to Part IVA. Part IVA should be the Commissioner's remedy – not just an alternative or fall back remedy. This is strongly preferred to an approach that upsets the long standing practice of being able to define trust income given that in most situations no mischief whatsoever is involved by adopting this practice.

Disputes as to tax net income

Where there is no deliberate attempt to exploit Div 6, ATO staff are still to raise amended assessments based on the Commissioner's view of income of a trust estate and share if there is a dispute

about the way the tax net income has been calculated.

The Commissioner provides a number of examples of how these situations may arise, namely:

- where the Commissioner reaches a view that a specific expense claimed was not deductible in calculating the trust's tax net income;¹⁷

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One may question whether the trust deed and its ability to redefine trust income is the real mischief here.

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- where the Commissioner reaches the view that a particular item of income was not taken into account in calculating the tax net income;¹⁸
- where the Commissioner forms the view that a person to whom an income distribution is purportedly made is not entitled to that income under the trust deed;¹⁹
- where a beneficiary purports to disclaim their interest in a trust but the Commissioner views the disclaimer as ineffective;²⁰
- where the trustee exercises a power to appoint income and the trust tax return discloses a loss;²¹
- where, due to inadvertence or a differing of views on the income of a trust estate, neither the trustee nor a beneficiary returns a net capital gain as tax net income.²²

Ensuring that the correct amount of tax net income (or an amount the Commissioner will agree) is calculated and returned will require a high degree of diligence from trustees and their advisers. If the Commissioner disputes the amount of tax net income returned, taxpayers are potentially exposed to amended assessments based on the Commissioner's views of share and income of a trust estate.

This may produce an even greater liability than what might otherwise be expected. For instance, in a dispute about the correct amount of a net capital gain derived by a trust with no ordinary income for the year in question, the Commissioner may choose to assess the trustee rather than the beneficiaries. The Commissioner would do this on the basis that it is legally impossible for the beneficiaries to be presently entitled

to the net capital gain. The net capital gain would not be income according to ordinary concepts and, in the Commissioner's opinion, nothing in the trust deed could alter this result. A s 99A assessment may therefore be raised against the trustee. Worse still, because the trustee is assessed under s 99A, the trustee would be denied the 50% discount.²³

UNANSWERED QUESTIONS

Regrettably, the Practice Statement has left many issues unanswered. For instance, what approach should be adopted where a trust taxpayer (rather than the ATO) amends its return after discovering that the full amount of its income was inadvertently understated? Is the taxpayer required to adopt the law as it stands or must the taxpayer adopt the Commissioner's views in their amended assessment? Arguably, if there has been no attempt to exploit Div 6, the taxpayer should be entitled to adopt the Full Federal Court position in *Bamford*, however, the position remains unclear.

The Practice Statement does not address the well established practice of streaming different sources of income and capital through trusts. Such activity in itself should not create a mismatch of beneficiary entitlements and tax outcomes. It should not ordinarily involve a dispute as to the tax net income. However, the Practice

Statement does not give any comfort on this issue. This is regrettable since the long standing practice of streaming through trusts is largely inconsistent with the Commissioner's view of income of a trust estate.

Of course, issues such as streaming through trusts will need to be revisited entirely if the Commissioner is successful in gaining special leave and then ultimately succeeds on a High Court appeal for *Bamford*.

APPROACH TO TRUST DISTRIBUTIONS IN THE FUTURE

Clearly, a high degree of diligence is required in preparing trustee distribution minutes in the current climate. If special leave to appeal the *Bamford* decision is granted, a High Court decision could not be expected until well after the end of the 2010 income year. If the Practice Statement remains in force for the 2010 (and perhaps the 2011) income years, it will be critical for advisers to carefully consider its implications in preparing trust distribution minutes and tax returns.

If, on the other hand, special leave is refused the Practice Statement is likely to be withdrawn. If this occurs, it remains to be seen whether the Commissioner will concede that the views he has expressed in the Practice Statement are wrong. Instead, the Commissioner may choose to issue a decision impact statement on the Full Federal Court decision in *Bamford* attempting to narrow its application to its facts.

While the Commissioner clearly has a duty to provide insight on how the law will be applied, the Commissioner should allow the law to speak for itself and not selectively apply it. As stated at the outset, allowing the Commissioner to choose when and when not to apply judicial decisions is, in the authors' view, entirely undesirable. Certainly, this approach to tax administration cannot assist advisers in attempting to bring certainty to their clients' affairs leaving aside its repugnance to the interests of justice.

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Reference notes

- 1 *Bamford v FC of T* 2009 ATC 20-105.
- 2 PS LA 2009/7 paras 4-5, 12, 46 -47, 64.
- 3 See for instance Ken Schurgott's paper in *Taxation in Australia, September 2009*; and Peter Slegers and George Hodson's article in CCH Tax Week "The Bamford Decision and Trust Net Income ... The Saga Continues" Issue 24, 18 June 2009.
- 4 For this reason, the trust income is sometimes also referred to in the case law as the "distributable income".
- 5 See, for instance, *prepayments affected by s 82KZMA*.
- 6 All of these situations are of course making assumptions about the nature of trust income – an issue which is in a state of flux. It can be assumed, however, that either taking the Commissioner's approach or applying a trust deed that is silent on the definition of income or defines the trust's income as "income according to ordinary accounting concepts", an excess tax net income situation is likely to arise.
- 7 *Bamford v FC of T* 2009 ATC 20-105, paras 36-40.
- 8 PS LA 2009/7 para 64.
- 9 PS LA 1998/1 para 8, PS LA 2009/7 preamble.
- 10 PS LA 2009/7, para 5.
- 11 *Ibid*, para 11.
- 12 *Ibid*, para 9.
- 13 *Ibid*, para 50-51.
- 14 *Ibid*, paras 53-55.
- 15 *Ibid*, paras 46-47.
- 16 *Ibid*, para 56-57.
- 17 *Ibid*, para 38.
- 18 *Ibid*, para 39.
- 19 *Ibid*, para 41.
- 20 *Ibid*, para 42.
- 21 *Ibid*, para 43.
- 22 *Ibid*, para 45.
- 23 Section 115-225 of the *Income Tax Assessment Act 1997 Act*.

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