

TAX BULLETIN

AN UPDATE PUBLICATION
FOR OUR CLIENTS

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CHANGES PROPOSED TO THE TAXATION OF TRUSTS

Overview

On 4 March 2011 the Assistant Treasurer announced proposed changes to the taxation treatment of trusts for the 2010/11 year of income (click [here](#)). These proposed changes have been identified as 'interim' measures to fix critical issues prior to a general re-write of the trust provisions into the 1997 Tax Act at a later date.

The Treasury discussion paper that accompanied the Assistant Treasurer's announcement contains two proposed changes, being:

- To change the meaning of "income of the trust" for the purposes of determining the allocation of tax liabilities to beneficiaries. This proposed amendment is likely to impact every trust that is making distributions for this income year.
- To clarify that trusts are able to stream dividends, franking credits and capital gains for tax purposes. This proposed amendment is likely to impact those trusts seeking to stream various classes of income for this income year.

A limited consultation period has been provided as submissions are due on 18 March 2011. Pitcher Partners will be making a submission on these important changes and we welcome your contribution to this process.

Changes to the meaning of "income of the trust"

The meaning of the phrase "income of the trust" is important, as this phrase is used to determine the respective tax liabilities of the beneficiaries and the trustee of a trust for an income year. That is, a beneficiary's share of the taxable (net) income of a trust is based on their proportionate share of the "income of the trust" to which they are presently entitled.

The Treasury paper highlights two main uncertainties in relation to the meaning of the phrase "income of the trust". The first uncertainty is in relation to the ability for trustee discretions to be applied to change the amount of the "income of the trust". The second uncertainty relates to whether particular amounts that a trustee calls "income of the trust" (pursuant to the relevant trust deed) are actually able to be distributed to beneficiaries. For example, if a trust deed defines "income" for trust purposes to equal taxable income, a question arises as to whether the notional franking credit gross-up can actually be an amount that a beneficiary can be presently entitled to.

In light of the two issues above, the Treasury paper proposes to have a statutory definition of "income of the trust" that would override the trust deed definition. Three options have been provided in the Treasury paper for consideration.



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- **Taxable income option** - The first option proposes to define “income of the trust” as the taxable income of the trust, adjusted for notional income and expense amounts. For example, a notional franking credit gross up and a notional investment allowance deduction would be excluded from the “income of the trust”.
- **Accounting profit option** - The second option would require the use of accounting concepts under GAAP to determine the “income of the trust”. That is, the accounting profit determined under GAAP would be considered to be the “income of the trust” for an income year. It is unclear whether this would require full AIFRS calculations and/or whether this would include all fair value movements required under relevant accounting standards.
- **Capital gains option** - The last option would still allow a trust deed to define “income” for trust purposes but would also ensure that capital gains are treated as “income of the trust” (i.e. where capital gains are not already included in the “income” definition of the trust deed). It is proposed that this option could be accompanied by a specific anti-avoidance provision that would operate if there is a change to the “income of the trust” that has the effect of manipulating tax liabilities (i.e. where discretions are applied by the trustee).

There are obviously issues that could be encountered under options one and two (i.e. the taxable income and accounting profit options), especially where the trust deed does not define income in a similar manner to the proposed legislative definition. For example, there will be cases where the statute defines an item as “income”, yet the deed does not recognise the amount as either income or capital in that year. A problem would therefore occur in trying to make the beneficiary “presently entitled” to that amount under the deed for that year, in order to avoid an assessment of the amount to the trustee at 46.5%.

Alternatively, while option three (the capital gains option) appears more flexible, a specific anti-avoidance provision may be seen as problematic from an administrative perspective and in achieving some degree of certainty in the application of these provisions.

Accordingly, careful consideration will be required of all of these three options in consultation with Treasury and the ATO on these proposed amendments.

Streaming franking credits and capital gains

The Treasury paper highlights the current uncertainty that exists in relation to the ability to stream various forms of taxable income to beneficiaries - i.e. post the recent decisions in the cases of *Bamford* and *Colonial First State*. This is due to statements in *Bamford* and *Colonial First State* to the effect that a beneficiary may be entitled to a proportion of the whole pool of taxable income, rather than on a class of income by class of income basis.

While a statutory scheme already exists for the streaming of franking credits, there is ambiguity in the drafting of these provisions. The Treasury paper has indicated amendments to these provisions that will provide certainty that a trustee is able to effectively stream dividends, and any accompanying franking credits, to certain beneficiaries.

Where capital gains are concerned, the Treasury paper outlines that the drafting of the current provisions may not allow for the ability to stream taxable capital gains to different beneficiaries. As with franking

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credits therefore, the Treasury paper states that amendments will be made to the capital gains provisions to specifically ensure that a trustee will be able to stream capital gains to certain beneficiaries.

Finally, it is highlighted that these proposed amendments are only limited to the classes of taxable income outlined above. Accordingly, other types of income, such as interest income will not fall within these amendments. It is expected that the ATO will release a view that a trust cannot stream these “other types” of income for tax purposes.

Concluding comments

While the proposed changes to clarify the ability to stream capital gains and dividends are welcome, the proposed changes to the definition of “income of the trust” may have significant implications - i.e. depending on the existing relevant definitions contained in the trust deeds. We will be making a submission on these issues by 18 March 2011. You are welcome to discuss any of your concerns with these proposed amendments with a Pitcher Partners representative.



FURTHER INFORMATION

Please ask either your regular Pitcher Partners tax contact or any of the contacts in the Pitcher Partners firms below for further details on the issues raised in this Tax Bulletin:

Melbourne

John Brazzale
john.brazzale@pitcher.com.au
+61 3 8610 5110

Alexis Kokkinos
alexis.kokkinos@pitcher.com.au
+61 3 8610 5170

Sydney

Chris Ardagna
cardagna@pitcher-nsw.com.au
+61 2 9223 1762

Adelaide

Richard Brooks
richard.brooks@pitcher-sa.com.au
+61 8 8179 2800

Tim Edgecombe
tim.edgecombe@pitcher-sa.com.au
+61 8 8179 2800

Perth

Julie Strack
strackj@pitcher-wa.com.au
+61 8 9322 1262

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