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THE HIGH COURT AND THE ATO RESHAPE THE TAX LANDSCAPE FOR TRUSTS

A High Court decision on taxation of trust income, and the ATO's response, have significant implications for how income from a trust estate is taxed. **By Simon Tisher**

The High Court decision of 30 March 2010 in *Commissioner of Taxation v Bamford; Bamford v Commissioner of Taxation*[1] (*Bamford*) and a Decision Impact Statement (DIS) of 2 June 2010 from the Australian Tax Office (ATO) have reconfigured the tax treatment of trusts. The implications are significant. If nothing else, practitioners should read their trust deeds carefully, having regard to the matters discussed below.

In *Bamford*, the High Court dismissed the Commissioner's appeal and the Bamfords' cross appeal. Put simply, the decision of the Court appears to have resolved that:

- a trust deed is able to define what "income" is for trust purposes; and
- a proportionate approach (rather than a fixed "quantum" approach) will be taken in applying a beneficiary's share of the "income" to the "net income" of a trust.

Although the *Bamford* decision and DIS have clarified some issues relating to the taxation of income of a trust estate, they have left other issues unresolved. These include the taxation of notional amounts such as deemed capital gains and franking credits, the ability to stream dividends, capital gains, interest and the ability to recharacterise receipts.

ILLUSTRATION PAT CAMBELL

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THE PROBLEM

At the heart of the dispute in *Bamford* were competing arguments about how s97(1) of Division 6 of the *Income Tax Assessment Act* 1936 (the 1936 Act) should be construed and applied. Although Division 6 has been modified several times over its legislative life, it "remains much as it was in 1936".[2]

The object of Division 6 is to secure payment of tax on the whole of the "net income" of a trust estate by either one or more beneficiaries or the trustee. This is regardless of whether that income is paid over to, or on account of, the beneficiaries.

The expression "net income" is defined in s95 of the 1936 Act. It is essentially taxable income, being the total assessable income of the trust estate calculated as if the trustee were a resident taxpayer in respect of that income, less all allowable deductions (with very limited exceptions).

No liability to tax attaches to a beneficiary of a trust estate unless they first become presently entitled to "income of the trust estate". So far as is relevant, s97(1) of the 1936 Act provides:

"Where a beneficiary of a trust estate who is not under any disability is presently entitled to a *share of the income of the trust estate*:

(a) the assessable income of the beneficiary shall include:

(i) that *share of the net income of the trust estate . . .*" (emphasis added).

The expression "present entitlement" on which s97 hinges has attracted much judicial consideration. Its meaning was not in dispute in *Bamford*. However, the Court affirmed its statement in *Harmer v FCT*[3] that a beneficiary would be presently entitled if, and only if, they have an interest in income that is vested in both interest and possession and if they have a present right to demand and receive payment of the income.[4]

To the extent there is "income of the trust estate" to which no beneficiary is presently entitled, the trustee is ordinarily assessed and is liable to pay tax on the net income of the trust estate, effectively at the highest rate of 46.5 per cent: s99A. Accordingly, Division 6 creates an impetus to distribute income rather than for it to be accumulated by the trustee.

One of the most difficult aspects of Division 6 is that the reference to "income of the trust estate" and "net income" in s97 mean different things and often result in different amounts.

Before *Bamford* it was thought that "income" (in the context of "income of the trust estate"), if undefined in the trust deed, meant income according to ordinary concepts. However, disagreement continued about the effectiveness of trust deeds modifying the definition of trust income or containing their own definition of income.

Once the present entitlement of a beneficiary to income of the trust estate was ascertained, the better view was that the beneficiary would be taxed on that same proportionate share of the net (taxable) income of the trust. Given the tendency for these to be different amounts, the possibilities for unfairness became clear. This was especially so where an excess of net income over trust income could result in a beneficiary being assessed on an amount they did not receive or get the benefit of. For example, a trust might have $10,000 of trust income and $15,000 of net (taxable) income. A beneficiary who became presently entitled to and who received $5000 of trust income (50 per cent share) would ordinarily be taxed on $7500 via the proportionate approach. In the case of capital gains, the ATO, through Practice Statement PS LA 2005/1 (GA), permitted different approaches to alleviate this unfairness.

THE FACTS

The facts in *Bamford* were not in dispute. Philip and Davina Bamford were the directors of P & D Bamford Enterprises Pty Ltd (the company). The company acted as trustee of the Bamford Trust, a family discretionary trust that was settled on or about 9 February 1995. The Bamford Trust deed had many features typical of a family trust, including flexibility of income distribution.

The company employed Mr and Mrs Bamford. On 20 May 2000, the company made a contribution of $175,000 to an offshore superannuation fund in respect of Mr and Mrs Bamford (as employees of the company). To fund that contribution, the company borrowed a sum of money from a bank and incurred interest expenses.

Neither "income" nor "capital" was defined in the trust deed. However, cl 7(n) of the trust deed permitted the trustee, in its discretion, to determine whether any amount was or was not to be treated as being on income or capital account. If no determination was made before the end of any given year, the income of the trust fund was to be calculated in the same manner as the net income under s95 of the 1936 Act.

There were two years of income in dispute. The issue raised in the year ended 30 June 2002 (2002 year) was the meaning of the expression "income of the trust estate" in s97(1). The sequential issue raised in the year ended 30 June 2000 (2000 year) was what "that share" of the income of the trust estate meant and how a beneficiary's "share of the net income" of a trust estate was to be calculated.

2002 year

In the 2002 year, the company treated as income a net capital gain of $29,227 (discounted by 50 per cent from $58,454) arising from the sale of real estate. It was common ground that, pursuant to cl 7(n) of the trust deed, the company treated the capital gain as income.[5]

The capital gain was divided equally and included in a distribution made to Mr and Mrs Bamford by the company. There was no other income for the trust for the 2002 income year.

A deduction of $16,100 was subsequently disallowed by the Commissioner. This was accepted by the company. This generated an excess of net (taxable) income over trust income that consisted entirely of a capital gain.

The Commissioner considered that the Bamford Trust deed had no effect in determining whether a beneficiary was presently entitled to a share of the "income of the trust estate" within the meaning of s97(1) and that the capital gain was not "income of the trust estate". He assessed the company to penal rates of tax under s99A on the basis that there was no "income of the trust estate" to which any beneficiary could be presently entitled.

2000 year

In the 2000 year, the trust income (and net income) of the company was $187,530. Included in this figure were deductions for the superannuation contribution and interest on the loan to fund the contribution, of $175,000 and $16,701.67 respectively.

In distributing its trust income, the company determined to distribute the amount of $68,000 to Mr and Mrs Bamford, to be shared equally. After distributions to other beneficiaries, a lesser figure of $33,872 was distributed to each of Mr and Mrs Bamford.

This was because there was insufficient income to distribute the full amount.

The Commissioner subsequently disallowed both amounts (superannuation contribution and interest) as deductions. In consequence, the net (taxable) income of the Bamford Trust exceeded its trust income (by $191,701.67).

Amended assessments were subsequently issued. The Commissioner assessed Mr and Mrs Bamford to tax on a proportionate share of the amount by which the tax income exceeded the trust income for the 2000 year. This included the additional aggregate amount of $34,624 as assessable income for each of them. The proportion that the amount of $34,624 bears to the sum of $191,701.67 is 18.062 per cent. That was the proportion that $33,872 bore to the total amount of $187,530 that was initially distributed.

THE ARGUMENTS

Relying on the decisions in *Totledge*[6] and *ANZ Savings Bank*,[7] the Commissioner argued that "income" meant income under ordinary concepts and that the proportionate approach was correct.

The company argued that "income" included income determined by the trust deed. It contended that the capital gain was income of the trust estate, that there was a beneficiary that was presently entitled and that the s99A assessment to the company was not competent.

The Bamfords contended they should pay tax only on the specific amount (quantum) of trust income that they were presently entitled to ($68,000).

THE DECISIONS

AAT and Full Federal Court

The Administrative Appeals Tribunal (AAT) affirmed both the objection decisions. Deputy Presidents Block and Walker found that the expression "income of the trust estate" meant ordinary income. They found that the terms of a trust deed could not alter the character of a receipt in the hands of a trustee.

The AAT also found that any excess of taxable income over trust income would be taxed in the hands of those beneficiaries presently entitled by reference to the proportion of trust income distributed to them. This was regardless of the fact that the entitlement of the Bamfords was expressed as a fixed dollar amount.

The Bamfords and the company appealed to the Full Federal Court. The appeal was allowed in relation to the 2002 year but dismissed in relation to the 2000 year. Stone and Perram JJ found that the "terms of the trust may have the effect of altering the income of the trust for s97 purposes". Their Honours held that the Full Court in *Cajkusic*[8] had decided that the terms of the trust deed could be taken into account, and agreed with them. Emmett J, on the other hand, decided that there was an assumption underlying Division 6 that a beneficiary who derives a share of the net income should be in a position to pay the tax out of that income.

Stone and Perram JJ agreed with Emmett J that "share" was to be determined in accordance with the proportionate approach.

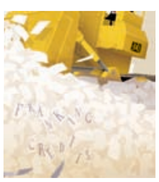
The Commissioner appealed and funded the Bamfords' cross appeal as a test case because of the inherent uncertainty created by the Full Court. He considered cases such as *Totledge* and *ANZ Savings Bank* supported the proposition that "income" was income under ordinary concepts. This, however, was contrary to the Full Court's decisions in *Bamford* and *Cajkusic*. He also considered that the proportionate approach could not be reconciled with Emmett J's approach to income.

High Court

In a relatively short decision handed down within a month, the High Court dismissed both appeals.

Central to the Court's reasoning for the 2002 year was its finding that the "very juxtaposition within s97" of "net income of the trust estate" and "the income of the trust estate" suggests that the latter "has a content found in the general law of trusts upon which Division 6 then operates". The Court similarly observed that "the language of present entitlement is that of the general law of trusts".

For the 2000 year, the Court quoted at length the reasoning of Sundberg J in *Zeta Force Pty Ltd v Commissioner of Taxation*.[9] Critically, in relation to s97, Sundberg J stated:



What is of concern is the extent to which the ATO considers the proportionate approach to operate.

"The words 'that share' in par (a)(i) refer back to the word 'share' in the expression 'a share of the income of the trust estate', and indicate that the same share is to be applied to an income amount calculated according to a different formula (taxable income as opposed to distributable income). Since the income amount may differ according to which formula is applied, the natural meaning to give to 'share' where it appears for the second time is 'proportion' rather than 'part' or 'portion'."

The Court stated that this analysis should be accepted and dismissed the Bamfords' cross appeal.

THE ATO DIS AND PS LA 2010/1

In the DIS, which was accompanied by Practice Statement PS LA 2010/1, the Commissioner said that:

- "income of the trust estate" takes its meaning from the general law of trusts;
- trust law presumptions "can be displaced by express provision in the trust instrument"; and
- once the amount of income to which a beneficiary is presently entitled has been ascertained, it is "converted into a percentage share".

Not surprisingly, the DIS acknowledges that "it might be expected that some taxpayers may wish to amend their deeds to insert a definition of income where one does not exist". It pointed out the risk of resettling the trust and referred to the Statement of Principles it released in August 2001.

What is of concern is the extent to which the ATO considers the proportionate approach to operate. In particular, the DIS states that "the amount included in a beneficiary's assessable income under s97 consists of an un-dissected or unallocated proportionate share of the entirety of the [tax] net income".

The reference to the inclusion in a beneficiary's assessable income of an "un-dissected or unallocated proportionate share" suggests that income streaming, a long-standing practice for many trustees, will not be possible from, and including, the year ending 30 June 2011 (even if permitted by deed). The element of surprise in this announcement was heightened by the fact that streaming was not considered in the *Bamford* decision.

There are other aspects of the DIS which similarly warrant careful attention. Several public rulings will be withdrawn with effect from the beginning of the 2011 income year. Principally, these include PS LA 2005/1 (GA) and Taxation Ruling TR 92/13.[10] PS LA 2005/1 (GA) outlined an alternative approach to alleviate unfairness for a beneficiary becoming assessed to a capital gain they did not have a vested and indefeasible interest in and were not allocated or for a beneficiary (typically a capital beneficiary) becoming entitled to a capital gain where there was no other income of the trust. The DIS states that PS LA 2005/1 (GA) must be withdrawn because of the *Bamford* decision.[11]

TR 92/13 dealt with trust dividends and franking and implicitly acknowledged that trustees could (if permitted by deed) "selectively allocate particular types of income to beneficiaries", that is, stream income. The announcement that it will be withdrawn adds concerns about the future of streaming, although the DIS states that it is being withdrawn because it concerns provisions that are no longer in force.[12]

The DIS also raises concerns about the effectiveness of re-characterisation clauses – that is, clauses that require or permit the trustee to treat as capital what is otherwise received as income.[13] The DIS states that these were not the facts before the High Court in *Bamford*.

Finally, the DIS lists many other areas that "remain uncertain". Examples include calculating trust income generally and where notional amounts (such as franking credits or deemed capital gains) are involved. The issue of how statutory flow-through provisions such as Subdivision 115-C of the *Income Tax Assessment Act* 1997 (the 1997 Act) (capital gains and trusts) interact with Division 6 is also listed as an area of uncertainty.

Of some comfort at this stage is the announcement in the DIS and in PS LA 2010/1 that the Commissioner will not generally seek to disturb returns for the year ended 30 June 2010 or earlier years if taxpayers relied on a view of Division 6 that was reasonably open before *Bamford*. Deliberate attempts to exploit Division 6 that come to the ATO's attention are an exception. Examples of such avoidance can be found in PS LA 2010/1.

The DIS also states that the ATO will consult interested practitioners. Submissions were accepted until 28 July 2010.

IMPLICATIONS

The immediate implications of the High Court's decision and the DIS are that:

- a trust instrument can define what "income" is for the purposes of determining "income of the trust estate";
- that definition can include capital gains or capital receipts;
- if a trust instrument does not define "income", the "income of the trust estate" will take its meaning from the general law of trusts; and
- once the amount of income to which a beneficiary is presently entitled has been ascertained, it is converted into a percentage share and applied to the net income of the trust to work out the amount that will be included in the beneficiary's assessable income.

The message for practitioners is: read your deed. In a win for taxpayers, particular importance will, now more than ever, be given to how the trust deed defines "income". Given the decision in *Bamford*, there is a compelling argument that it will be appropriate in many instances for the trustee to adopt a definition of "income" that at least includes discretion for the trustee to determine what income is.[14]

Although there are many options as to how "income" can be defined, it should be done with care; the ATO has warned of the risks of resettlement. Check also that the deed contains provision for such amendments.[15]

The future of income streaming appears to be in real doubt, given the comments in the DIS. Watch, however, for further announcements from the ATO.

Although there now appears to be no doubt that the proportionate approach is correct, the approval given to the proportionate approach by the High Court and the removal of PS LA 2005/1 (GA) will leave some beneficiaries exposed to excessive tax where the taxable income of the trust exceeds its trust income.

There have been many calls for either wholesale clarification or repeal of Division 6. Indeed, the High Court in *Bamford* noted that "it is more than 20 years since Hill J observed that 'the scheme of Division 6 calls out for legislative clarification'".[16] More recently, recommendation 36 of the *Australia's Future Tax System Review* (the Henry Review) called for the current trust rules to be "updated and rewritten to reduce complexity and uncertainty around their application".

Given that the DIS has identified many uncertainties with Division 6, it appears that there is as much merit as ever in calls for legislative intervention. ●

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1. [2010] HCA 10.
2. *Dwight v FCT* (1992) 92 ATC 4192 at 4196.
3. (1999) 173 CLR 264.
4. *Bamford*, note 1 above, at [37]. See also *FCT v Whiting* (1943) 66 CLR 199 and *Taylor v FCT* (1970) 119 CLR 444.
5. Interestingly, the company had made no express determination pursuant to cl 7(n) of the trust deed that any capital gain was to be treated as being on income account.
6. *FCT v Totledge Pty Ltd* (1982) 82 ATC 4168.
7. *FCT v Australia and New Zealand Savings Bank Limited* (1998) 194 CLR 328.
8. *Cajkusic v Commissioner of Taxation* [2006] FCAFC 164.
9. (1998) 84 FCR 70 at 74-75.
10. Other rulings to be withdrawn include TR 95/29, IT 331 and PS LA 2009/7.
11. Because of the approval given to the proportionate approach.
12. The current dividend imputation provisions were rewritten into Division 207-B of the 1997 Act.
13. See also the DIS issued on 4 May 2010 in respect to *Forrest v Commissioner of Taxation* [2010] FCAFC 6.
14. Note, however, that the ATO states that a re-characterisation clause cannot contradict other requirements of the trust instrument such as the settlor's intention. See also the DIS of 4 May 2010, note 13 above.
15. Caution should also be exercised in the accounting treatment adopted by the trustee. In *Clark v Inglis* [2010] NSWCA 144, the NSW Court of Appeal found that the trustee had treated certain unrealised gains in trust assets (shares) as income of the trust estate pursuant to accepted accounting concepts, and had distributed the income to beneficiaries of the trust (without cash and through the use of loan accounts). The trust deed in that case did not define income, although it did permit the trustee to determine whether a receipt constituted capital or income.
16. *Bamford*, note 1 above, at [17].