

Streaming capital gains... if any

THE RESPONSE TO THE HIGH COURT'S DECISION IN BAMFORD HAS IGNITED DEBATE ON THE ABILITY TO STREAM CLASSES OF INCOME TO TRUST BENEFICIARIES. THIS ISSUE HAS FAR REACHING IMPLICATIONS AND STRIKES AT THE TAX EFFECTIVENESS OF TRUST STRUCTURES MOVING FORWARD.



The landmark *Bamford*¹ decision has resolved two long standing questions about the taxation of trust beneficiaries and trustees under s 97 of the *Income Tax Assessment Act 1936 (ITAA36)*. First, that “income of the trust estate” to which a beneficiary is presently entitled is determined in accordance with general trust law rather than ordinary concepts of income.² Second, that in determining how much of a trust’s net income (ie tax income) is assessed to beneficiaries, a proportionate rather than quantum approach applies.³ That is, the beneficiary’s proportionate or fractional entitlement to the income of the trust estate is applied in determining that beneficiary’s share of the trust’s net income.

The proportionate approach is illustrated in Example 1 below:

STREAMING CLASSES OF INCOME

Despite the authority provided by the High Court on the two questions described above, a number of issues

remain unresolved. One such question emerging in the post-*Bamford* analysis is the effectiveness of streaming classes of income amongst beneficiaries.

The ability to selectively stream different classes of income is a key attraction of the trust structure. In Taxation Ruling 92/13, the Australian Tax Office (ATO) recognises the “conduit” theory which holds that income retains its character in the hands of beneficiaries.⁴ Subject to the trust’s deed, a trustee may selectively distribute different classes of income to different beneficiaries or classes of beneficiaries. A beneficiary’s share in the net income of the trust then retains that character. If selective streaming is not permitted by the deed or the character of income cannot be traced, the various classes of income are distributed rateably amongst beneficiaries.

The ability to selectively stream income and capital clearly has significant tax planning advantages. For example,

imputation credits flow through to the extent that the beneficiary’s income is attributable to franked dividends.⁵ Further, a beneficiary’s own capital losses are applied against the beneficiary’s share of a trust’s capital gain.⁶

Whether the conduit theory does in fact extend to capital gains is contentious. The ATO formerly recognised in IT 2328 that capital gains retain their character in the hands of beneficiaries.⁷ This was withdrawn in 2008 on the grounds that the ruling was no longer necessary following the re-write of the relevant capital gains provisions. Some commentators have also highlighted the difficulties in applying conduit theory to all types of trusts.⁸ Therefore, there are some limitations to the theory that, at general law, both income and capital gains can be streamed to beneficiaries. However, one question to consider post-*Bamford* is the extent to which conduit theory is reflected

EXAMPLE 1: THE PROPORTIONATE APPROACH

The ABC Trust makes a \$100,000 capital gain and receives \$10,000 rental income. The trust’s deed requires the gain to be treated as a capital receipt and this amount is accumulated. The trustee distributes \$2,000 of the rental income to beneficiary A and \$8,000 to beneficiary B.

The trust’s net income (ie tax law income) includes both the net capital gain and the rental income. To determine how much of this is attributable to the beneficiaries, s 97(1) requires us to consider what proportion of the “income of the trust estate” they are entitled to. Here, the “income of the trust estate” only includes the \$10,000 rental income. This is because *Bamford* confirms that “income of the trust estate” is determined by trust law principles. Recall that the Trust’s deed requires the gain to be treated as a capital receipt.

Beneficiary A is entitled to \$2,000 which is 20% of the “income of the trust estate”. Beneficiary B is entitled to \$8,000 which is 80%. Applying the proportionate approach confirmed in *Bamford*, these proportions are applied to the Trust’s net income and beneficiaries A and B are assessed on 20% and 80% respectively of the Trust’s net income, which includes the rental income and capital gain (total trust income of \$110,000). Beneficiary A is assessed on 20% or \$22,000 and beneficiary B is assessed on 80% or \$88,000. This is the result, even though beneficiaries A and B in fact only received distributions of \$2,000 and \$8,000 respectively.

in the express provisions of the taxation legislation and whether selective streaming is possible.

In response to the *Bamford* decision the ATO released Practice Law Administration Statement PS LA 2010/1 and a Decision Impact Statement. These outline the ATO's view that, subject to other taxation provisions, the proportionate approach endorsed by the High Court does not depend on the character or class of income to which beneficiaries are entitled. That is, each beneficiary's share in the net income of the trust represents an "un-dissected or un-allocated" proportionate entitlement.⁹

The implication is that, but for any statutory provision (eg s 6B of ITAA36), each beneficiary shares in a proportionate amount of each class of income. The distorted character that results where selective streaming is not possible and beneficiaries are taken to share in classes of income proportionately could have a potentially significant impact on the tax payable by beneficiaries. This may detract from the tax effectiveness of trusts generally as illustrated in Example 2.

STREAMING CAPITAL GAINS

The ATO suggests in its Decision Impact Statement that TR 92/13 must be withdrawn on the basis that it concerns provisions no longer in force (ie trust dividend income provisions which have subsequently been re-written¹⁰). No suggestion is made that the approach of the ATO generally in TR 92/13 is inconsistent with the result in *Bamford*.

However, the planned withdrawal, announced as part of the *Bamford* Decision Impact Statement, raises concerns that the ATO may seek to extend the proportionate approach in *Bamford* to effectively rule out income streaming.

While this issue warrants further examination, a number of points can immediately be made regarding income streaming. First, the *Bamford* decision did not consider income streaming and is not authority for the proposition that the proportionate approach necessarily requires that beneficiaries also share proportionately in each class of income. Further, the trust capital gains rules in subdiv 115-C, which operate to attribute capital gains to trust beneficiaries as discussed below, lend support for the view that amounts may be selectively streamed to beneficiaries. These rules are not simply deeming provisions which operate independently of s 97, but rather they might shed light on how s 97 itself operates.

To apply subdiv 115-C, the provisions can be broken down into several steps:

Step 1: does the trust have a net capital gain?

Subdivision 115-C only applies if a trust has a net capital gain that is taken into account in working out the trust's net income for an income year.¹¹ If a trust does not have a net capital gain in an income year, the subdivision is not triggered.

Step 2: if yes, does the beneficiary have a share in the net income of the trust?

If a trust does have a net capital gain, the subdivision operates to attribute part of the gain to the trust's beneficiaries. In order to determine how much of the gain is attributed to a particular beneficiary, the beneficiary must determine whether their assessable income for the year includes a share of net income of the trust pursuant to s 97 of ITAA36.¹² (As described above in example 1, *Bamford* now provides the authority for how to make that determination.)

If the beneficiary has no share of the net income of the trust, they are not treated as sharing in any of the trust's capital gains and the subdivision does not apply to that beneficiary.

If the beneficiary's assessable income does include a share of the income of the trust pursuant to s 97, the amount is referred to as that beneficiary's **trust amount**.

Step 3: if yes, for each capital gain of the trust, what part, if any, is attributable to the beneficiary?

If the beneficiary has a trust amount, the beneficiary must consider each capital gain that has been made by the trust. Specifically, the provisions state that for each capital gain of the trust, the beneficiary is treated as having a capital gain equal to the part, *if any*, of their trust amount that is attributable to that capital gain of the trust.¹³ (This is discussed in detail later.)

EXAMPLE 2: CHARACTER OF DISTRIBUTIONS

The XYZ Trust makes a \$150,000 capital gain and receives \$50,000 ordinary income. The deed permits capital receipts to be treated as income. The deed also permits selective distribution of classes of income to different beneficiaries. The trustee determines to distribute the \$150,000 gain as income to beneficiary X. The \$50,000 amount of ordinary income is distributed to beneficiary Y.

Applying the proportionate approach, beneficiary X is assessed on 75% of the trust's net income (ie \$150,000 of \$200,000 total net income). Beneficiary Y is assessed on 25%.

However, if the correct view is that selective streaming is not possible, beneficiary X's share of the net income does not retain its character wholly as a capital gain. Rather, 75% of the capital gain is attributable to beneficiary X and 25% of the gain to beneficiary Y. Similarly, 75% of the ordinary income is attributable to beneficiary X and 25% to beneficiary Y.

In applying subdiv 115-C (discussed below), beneficiary X is taken to have a capital gain equal to 75% of the trust's capital gain. On the other hand, if the selective distribution of capital to beneficiary X was recognised, he would have been taken to have a capital gain equal to the whole capital gain.

The difference in outcomes may have a material impact on beneficiary X and Y's tax positions, depending on the capital losses each has available to apply against their share of the gain and their ability to apply the 50% discount.

Step 4: if the beneficiary is entitled to any part of one or more of the trust's capital gains, the beneficiary applies its own concessions.

The capital gains, if any, attributed to the beneficiary are then grossed up for the purposes of allowing the beneficiary to apply, if applicable, its own losses, the 50% discount and 50% small business reduction.¹⁴ The beneficiary is also entitled to a deduction equal to the part of their trust amount attributable to the trust net capital gain.¹⁵ This is to ensure they are not taxed twice on that amount.

The key step which is relevant to the debate surrounding income streaming is step 3. If selective streaming were not possible, the amount of each applicable trust capital gain to attribute to the beneficiary would simply be equal to the capital gain multiplied by the beneficiary's proportional entitlement (ie that worked out under the proportionate approach confirmed in *Bamford*). If this were the case, it would appear there is no need to use the expression "if any" in step 3. In order to arrive at step 3, it must be the case that (1) the trust has a net capital gain for that year and (2) the beneficiary's assessable income includes a share of the trust's net income.

Instead, the use of the expression "if any" suggests that a beneficiary can share in the net income of the trust in the same year that the trust has a net capital gain, but the beneficiary's share might not necessarily be attributable to a particular capital gain. One explanation for this outcome is that capital gains have been selectively streamed and the particular beneficiary was not entitled to that particular capital gain. For example, the beneficiary might share in the ordinary income component of the trust's net income and not its capital gain.

ALTERNATIVE EXPLANATION

Besides selective income streaming, are there other situations that could give rise to the same outcome, ie where no part of a beneficiary's share of the net income of the trust is attributable to a particular capital gain?

It is possible that the expression "if any" is adopted to ensure beneficiaries are not incorrectly taxed on gains which are

otherwise not assessable to the trust. These could include, eg a capital gain from the disposal of a pre-CGT asset or a capital gain to which a roll-over applies. In both cases, there is no capital gain included in the net income of the trust for that year.

Fortunately, a beneficiary would not be incorrectly taxed on such gains. Subdivision 115-C provides that each capital gain of the trust must be considered separately and a beneficiary is only treated as having a share of a particular capital gain if part of the beneficiary's "trust amount" (ie its share in the net income of the trust) is attributable to that capital gain¹⁶. A disregarded capital gain from a pre-CGT asset or a gain to which a roll-over applies would not be included in the net income of the trust and therefore would not form part of a beneficiary's share in the net income. This would result in the relevant part being "nil" and therefore, provides an alternative explanation as to why the expression "if any" is used.

However, it is possible for both explanations to be accommodated. The wording of the legislation also hints that there might be a broader purpose. The words "if any" are repeated three times in the legislation; if selective income streaming were not possible and the alternative explanation given above was the only reason for using that expression, this could arguably have been addressed more simply. Instead of asking taxpayers to consider "each capital gain of the trust estate", the legislation could simply examine "each capital gain of the trust estate that was taken into account in working out the trust estate's net capital gain".

STREAMING AND THE PROPORTIONATE APPROACH, SIDE BY SIDE?

In summary, there is evidence to suggest that the drafters of subdiv 115-C contemplated that trustees can selectively stream capital gains. This is supported by the accompanying explanatory memorandum, which explained that "the beneficiary will need to know what proportion of their entitlement to the net income of the trust is attributable to capital gains".¹⁷ Notably, the decision in *Bamford* regarding the proportionate approach confirms the earlier 1998 decision of the Federal Court in *Zeta Force*.¹⁸ Essentially, *Bamford* does not represent any change

in thinking from that endorsed by *Zeta Force*.¹⁹ Subdivision 115-C was enacted in 1999²⁰ after the *Zeta Force* decision was handed down. Therefore, subdiv 115-C was drafted in the context of the Federal Court authority for the proportionate approach, and yet it appears that selective income streaming is still possible under the legislation. This adds weight to the view that the proportionate approach and income streaming can exist side by side.

While the express provisions of subdiv 115-C provide an indication that capital gains may be streamed to beneficiaries for capital gains tax purposes, the question remains whether the taxation of beneficiaries generally, including the operation of s 97, is premised on the concept that income retains its character and that it may be selectively streamed. In this regard, subdiv 115-C offers some insight. Although it deals with a discrete type of statutory income (ie trust capital gains), subdiv 115-C is not drafted in a way that deems streaming to be possible for statutory purposes. Rather, it might reflect a view that trust distributions have an inherent character which flows through to beneficiaries and that these can be selectively streamed. This issue clearly has significant implications for trusts and requires further examination. However, in the absence of thorough judicial consideration, care must be taken not to extend the principles in *Bamford* to areas which go beyond the subject matter of the High Court's decision.

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Reference notes

- 1 *Commissioner of Taxation v Phillip Bamford & Ors; Phillip Bamford & Anor v Commissioner of Taxation* [2010] HCA 10.
- 2 *Ibid* 36 – 41.
- 3 *Ibid* 43 – 46.
- 4 *Taxation Ruling TR 92/13* at 16.
- 5 *Subdivision 207-B of the Income Tax Assessment Act 1997 (ITAA36)*.
- 6 *Subdivision 115-C of the ITAA97*.
- 7 *Taxation Ruling IT 2328 (withdrawn)* at 13.
- 8 See, eg "Administration of SME Trusts" by R Jorgensen, *Taxation Institute of Australia's National Convention*, 12 March 2009 at 3.

- 9 ATO Decision Impact Statement of 2 June 2010 regarding *Commissioner of Taxation v Phillip Bamford & Ors; Phillip Bamford & Anor v Commissioner of Taxation*, S310 and S311/2009.
- 10 The current provisions are contained in Subdivision 207-B of the ITAA97. Part IIIAA of the ITAA36 ceased to have effect from 1 July 2002.
- 11 Section 115-210(1) of the ITAA97.
- 12 Section 115-215(2) of the ITAA97.
- 13 Section 115-215(3) of the ITAA97.
- 14 Sections 115-215(3) and 115-215(4) of the ITAA97.
- 15 Section 115-215(6) of the ITAA97.
- 16 Section 115-215(3) of the ITAA97.
- 17 Explanatory Memorandum, *New Business Tax System (Integrity And Other Measures) Bill 1999*, at 11.18.
- 18 *Zeta Force Pty Ltd v Commissioner of Taxation* (1998) 84 FCR 70.
- 19 *Commissioner of Taxation v Phillip Bamford & Ors; Phillip Bamford & Anor v Commissioner of Taxation* [2010] HCA 10 at 45.
- 20 Inserted by the *New Business Tax System (Integrity and Other Measures) Act 1999*.