TD 2024/D2 - Income tax: factors taken into account in applying the exceptions to section 99B of the Income Tax Assessment Act 1936 contained in paragraphs 99B(2)(a) and 99B(2)(b)

For information about the status of this draft Determination, see item 4087 on our Advice under development program.

Status: **draft only – for comment**

Draft Taxation Determination

Income tax: factors taken into account in applying the exceptions to section 99B of the *Income Tax Assessment Act 1936* contained in paragraphs 99B(2)(a) and 99B(2)(b)

Relying on this draft Determination

This publication is a draft for public comment. It represents the Commissioner's preliminary view on how a relevant provision could apply.

If this draft Determination applies to you and you rely on it reasonably and in good faith, you will not have to pay any interest or penalties in respect of the matters covered, if this draft Ruling turns out to be incorrect and you underpay your tax as a result. However, you may still have to pay the correct amount of tax.

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What this draft Determination is about

1. Paragraphs 99B(2)(a) and 99B(2)(b) of the *Income Tax Assessment Act 1936* exclude certain amounts of trust property paid to, or applied for the benefit of, resident beneficiaries from being assessed under subsection 99B(1) and depend upon specific tests, referred to in this draft Determination[1] as the hypothetical resident taxpayer tests.

2. This Determination sets out our view on whether the following are relevant in applying the hypothetical resident taxpayer tests:

- characteristics of the hypothetical taxpayer other than residency
- in determining whether an amount would be assessable, the circumstances that gave rise to the relevant amount in the hands of the trustee, and
- the source of the amount paid or applied to the beneficiary.

3. All legislative references in this Determination are to the *Income Tax Assessment Act 1936*, unless otherwise indicated.

Ruling

4. For the purposes of the hypothetical resident taxpayer tests, the only characteristic of the hypothetical taxpayer is that they are an Australian resident.

5. Further, in applying the hypothetical resident taxpayer tests to determine whether or not an amount would be assessed in the hands of the hypothetical taxpayer, it is necessary to consider the circumstances that gave rise to the relevant amount in the hands of the trustee.

6. The ultimate source of the amount paid or applied to the beneficiary is also taken into account in determining whether it is ‘attributable to’ amounts which would be assessed in the hands of a hypothetical resident taxpayer for the purposes of paragraph 99B(2)(a) or whether an amount ‘represents’ an amount that would not have been assessable if derived by the hypothetical resident taxpayer for the purposes of paragraph 99B(2)(b).

Example 1 – CGT asset acquired before 20 September 1985

7. *The trustee of a non-resident trust estate acquired land on the settlement of the trust in 1982. In 2024, the trustee disposes of the land. The proceeds of sale are distributed to a resident beneficiary.*

8. *In determining, for the purposes of the hypothetical resident taxpayer tests, whether the proceeds would have been included in the assessable income of the hypothetical taxpayer, consideration is given to the fact that the land was acquired before 20 September 1985.*

9. *The CGT provisions*[2] *disregard a capital gain in these circumstances, meaning that the amount that is attributable to or represents a capital gain would not have been included*

[1] For readability, all further references are to ‘this Determination’ as it will read when finished. Note that this Determination will not take effect until finalised.

[2] Section 104-10 of the *Income Tax Assessment Act 1997* (ITAA 1997). Note other CGT provisions affect the capital gain calculation (for example, section 118-20 of the ITAA 1997 may reduce a capital gain if an amount is assessable or exempt by a provision outside of Part 3-1 of the ITAA 1997 because of the CGT event prior to being disregarded).

in the assessable income of the hypothetical taxpayer. As a result, no part of the distribution is included in the beneficiary's assessable income under subsection 99B(1).

Example 2 – distribution from a non-resident deceased estate

10. *Following the death of a non-resident, the non-resident executor of the deceased's estate disposes of shares which had been acquired by the deceased on 1 September 1991, and distributes the proceeds to a resident beneficiary.*

11. *Division 128 of the ITAA 1997 sets out what happens when a CGT asset owned by a deceased devolves to their estate or passes to a beneficiary. Specifically, it modifies the cost base and reduced cost base of the CGT asset in the hands of the legal personal representative, executor or beneficiary.*

12. *The acquisition of the shares by the deceased estate from the deceased is relevant to the derivation of the amount distributed by the trustee.*

13. *In determining, for the purposes of the hypothetical resident taxpayer tests, whether the proceeds of sale would have been included in the assessable income of the hypothetical taxpayer, consideration is given to the fact that the shares were acquired by the trust estate following the death of the non-resident at the cost base deemed under Division 128 of the ITAA 1997.*[3]

Example 3 – CGT discount not available to hypothetical taxpayer

14. *A non-resident trust estate acquires shares using income from its trading activities and in a later income year sells the shares and distributes the proceeds to an Australian-resident beneficiary.*

15. *In applying the hypothetical resident taxpayer tests to determine whether the whole or any part of the distribution would or would not be included in the assessable income of the hypothetical resident taxpayer, the only relevant characteristic of the hypothetical taxpayer is their status as an Australian resident.*

16. *This means that the CGT discount cannot be taken into account to reduce the amount which may be included in the assessable income of a hypothetical resident taxpayer.*[4]

Date of effect

17. When the final Determination is issued, it is proposed to apply both before and after its date of issue. However, the Determination will not apply to taxpayers to the extent that it

[3] The first element of the cost base of the shares will generally be deemed to be equal to the deceased's cost base (per table item 1 of subsection 128-15(4) of the ITAA 1997), though there are some exceptions. For example, the first element of the cost base will instead be the market value of the shares on the date of death if the deceased is a non-resident (per table item 3A of subsection 128-15(4) of the ITAA 1997) or if the shares were acquired prior to 20 September 1985 (per table item 4 of subsection 128-15(4) of the ITAA 1997).

[4] See Taxation Determination TD 2017/24 *Income tax: where an amount included in a beneficiary's assessable income under subsection 99B(1) of the Income Tax Assessment Act 1936 had its origins in a capital gain from non-taxable Australian property of a foreign trust, can the beneficiary offset capital losses or a carry-forward net capital loss ('capital loss offset') or access the CGT discount in relation to the amount?*

conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Determination (see paragraphs 75 to 76 of Taxation Ruling TR 2006/10 *Public Rulings*).

Commissioner of Taxation
31 July 2024

Status: **draft only – for comment**

Appendix 1 – Explanation

This Explanation is provided as information to help you understand how the Commissioner's preliminary view has been reached. It does not form part of the proposed binding public ruling.

Section 99B

18. Subject to subsection 99B(2), subsection 99B(1) requires a beneficiary to include in their assessable income an amount of trust property that is paid to, or applied for their benefit[5], provided the beneficiary was resident at any time during the income year in which the payment or application was made.[6]

19. Subsection 99B(2) excludes certain amounts from the scope of subsection 99B(1). Most relevantly:

- paragraph 99B(2)(a) excludes an amount representing corpus of the trust estate, except to the extent to which it is attributable to amounts derived by the trust estate that, if they had been derived by 'a taxpayer being a resident', would have been included in the assessable income of that taxpayer for a year of income, and
- paragraph 99B(2)(b) excludes an amount representing an amount that, if it had been derived by a taxpayer being a resident, would not have been included in the assessable income of that taxpayer of a year of income.

Corpus for paragraph 99B(2)(a)

20. Corpus refers to trust capital or the assets of the trust as distinct from trust income.

21. To the extent that a distribution of trust corpus is attributable to accumulations of income (which have been capitalised and which would have been assessable if derived by a resident but which have not otherwise borne tax in Australia), the corpus exception in paragraph 99B(2)(a) will not apply as a result of the operation of the hypothetical resident taxpayer test in that paragraph.

The hypothetical resident taxpayer tests

22. The Full Federal Court in *Howard v Commissioner of Taxation* [2012] FCAFC 149 *(Howard)* articulated the hypothetical resident taxpayer test in paragraph 99B(2)(a) as [7]:

> … The excision requires the positing of a hypothesis and the posing of a question premised on that hypothesis. The hypothesis posited is that the amount received by the Esparto Trust estate was derived by a resident taxpayer; the question posed on its assumption is whether that resident taxpayer would have been required to include the amounts it received as assessable income.

23. The hypothesis, therefore, posited for paragraph 99B(2)(a) is that the amounts derived by the trustee were, instead, derived by a hypothetical resident taxpayer. The

[5] Section 99C contains rules for determining whether an amount has been paid or applied for the benefit of a beneficiary for the purposes of section 99B.
[6] If amounts are included in the assessable income of a beneficiary under section 99B, that beneficiary may also be liable to pay interest under section 102AAM.
[7] [2012] FCAFC 149 at [37].

question premised on this hypothesis is whether the amounts would be included in the assessable income of that resident taxpayer.

24. Paragraph 99B(2)(b) similarly enquires whether the amount paid or applied for the benefit of the beneficiary represents an amount that, if it had been derived by a hypothetical resident taxpayer, would not be included in the assessable income of that taxpayer.

25. The hypothetical resident taxpayer tests raise 2 questions:

- In posing the hypothesis, what characteristics are ascribed to the hypothetical taxpayer?
- In answering the question as to whether amounts would or would not be included in the assessable income of that taxpayer, what characteristics of the amount in question can be considered?

Characteristics of the hypothetical taxpayer

26. The hypothesis posited, being that the amounts were derived by a resident taxpayer, differs from actual fact, which is that they were derived by the trustee of the trust estate.

27. This was recognised by the Full Federal Court in *Howard*, in relation to paragraph 99B(2)(a), as in that case the amounts derived by the trustee of the Esparto Trust were not derived by a resident (the trustee being resident in the Isle of Jersey) and because, being a trustee, the amounts were not derived by a taxpayer.

28. It is also evident from the language of paragraphs 99B(2)(a) and 99B(2)(b) that the hypothetical taxpayer is not the beneficiary or trustee of the trust estate, but an entirely separate, fictional entity.

29. Moreover, paragraph 99B(2)(b) identifies the hypothetical taxpayer without reference to any trustee.

30. Both paragraphs 99B(2)(a) and 99B(2)(b) employ the indefinite article ‘a’ to identify a non-specific taxpayer deriving the amount in a non-specific year of income. This indicates that the hypothesis in these provisions is concerned with resident taxpayers generally, rather than a particular trustee or beneficiary. Nor do those paragraphs refer to any particular category of taxpayer (such as an individual, trust, or a company).

31. Therefore, the characteristics of the hypothetical taxpayer are limited to those expressed in the hypothesis – namely, residence in Australia. It cannot be assumed that the hypothetical taxpayer has any other characteristics.

32. A similar issue arose in *Union Fidelity Trustee Co (Aust) Ltd v Commissioner of Taxation (Cth)* [1969] HCA 36. In that case, the High Court considered the ‘taxpayer’ hypotheses arising under the then section 99 and section 95 (net income definition) which did not specify a further hypothesis of Australian residence. Barwick CJ and Kitto J (with whom Windeyer J agreed) were both disinclined to have regard to the ‘actual’ residence status of the trustee preferring instead to have regard to only that which had been hypothesised (a taxpayer) [8]:

> … For the purpose of this abstraction or computation the only fact which is relevantly known is that the trustee, as a taxpayer, has derived the income. The residence of the trustees, or

[8] [1969] HCA 36; 119 CLR 177 at [181], per Barwick CJ.

> of any one of them, if there be more than one cannot afford a reason for varying the net amount of the income of the trust estate according to the accident of the trustee's residence in the year of tax. Its irrelevance is emphasized when the possibility of diverse residences of several trustees is contemplated.

33. Although the statutory context is somewhat different, the approach taken in this matter is considered to inform the appropriate approach to be taken in the context of section 99B. The approach is also informed by the Full Federal Court's approach in *Howard* which referred to the hypothetical taxpayer merely being a resident taxpayer and importing no additional factors.

34. Because the only relevant characteristic of the hypothetical taxpayer is their status as an Australian resident, concessions such as the CGT discount available under Division 115 of the ITAA 1997 are not taken into account when determining whether an amount would or would not be included in the assessable income of a hypothetical taxpayer. This is because the CGT discount is not available to all resident taxpayers and is only available to specific classes of resident taxpayers. Given we can only say that the hypothetical taxpayer is an Australian resident, we cannot assume any other factors such as entity type that would mean regard could be had to the CGT discount.[9]

Characteristics of the amount

35. The circumstances of derivation, meaning factors attributable to the transaction that generated the amount, can be considered in the hypothesis. This is consistent with the language of paragraphs 99B(2)(a) and 99B(2)(b) which hypothesise a scenario in which the amounts are 'derived' by a resident taxpayer, as opposed to the trustee of the trust estate.

36. In the first instance decision of *Howard v Commissioner of Taxation (No 2)* [2011] FCA 1421, Jessup J stated[10]:

> … The question which then arose was whether so much of the corpus as was represented by the distribution would, had it been derived by a resident taxpayer, have been included in his or her assessable income. This looks to the character of the corpus by reference to the circumstances of its derivation. In the present case, the relevant accretion to the corpus of the Esparto Trust was derived by way of the proceeds of the sale-back to Esparto of the shares held in the name of Juris.

37. It is relevant and necessary to consider at least certain facts about the amount received by the trust estate on the basis that those facts form part of the circumstances of derivation. Without importing some facts, the trust estate is simply taken to have received proceeds or amounts with no characteristic on which it is possible to make an assessment whether, or what part, that hypothetical taxpayer would be assessed on.

38. In *Howard,* the task was straightforward due to there being only one significant, identifiable transaction. The Full Federal Court considered the relevant circumstances and attributes to include that there were proceeds from an off-market share buy-back and then asked the question whether a hypothetical Australian taxpayer would be assessed on such amounts.

39. The characteristics of the amount therefore encompass the circumstances (and the tax attributes arising from them) that result in the trust estate receiving amounts (for

[9] TD 2017/24.
[10] [2011] FCA 1421, at [180].

example, funds or assets) which are subsequently distributed to an Australian beneficiary, thus triggering the operation of subsection 99B(1).

40. Where a trust estate has a capital asset with a cost base and disposes of the asset to realise proceeds which are then distributed, those are circumstances giving rise to the receipt of funds which are relevant in applying the hypothetical resident taxpayer test. Similarly, where a non-resident trust estate receives a capital asset following the death of an owner, those circumstances are relevant.

41. Where an amount received by a beneficiary is attributable to capital proceeds from a dealing with a CGT asset, things that happen at the time of initial acquisition of the capital asset are relevant characteristics for the purpose of the hypothetical resident taxpayer test as they allow the test to work.

42. Facts and events other than those that relate to the character of the amount at the time of its derivation are not relevant to the hypothetical resident taxpayer test. In particular, actions taken by the trustee or things that happen to the trustee after acquiring an asset are not relevant. For example, the ongoing ownership structure or residency status of a trust that held a capital asset is not a characteristic of the amount or a circumstance of the derivation of the resulting proceeds.

Example 4 – circumstances of derivation

43. *A resident beneficiary receives a payment from the trustee of a non-resident trust that is from the proceeds from disposal of a CGT asset. The CGT asset was acquired by the trustee in 2000 with funds settled upon the trust at the time the trust estate was established.*

44. *For the purposes of the hypothetical resident taxpayer tests, the circumstances of derivation, such as the factors attributable to the transaction that generated the amount distributed, will be considered in the hypothesis.*

45. *As such, the acquisition date (being after 20 September 1985) and the trustee's cost base are relevant to the derivation of the proceeds. The amount (if any) by which the proceeds exceed the cost base represents a gain which would be assessable to a hypothetical resident taxpayer. To that extent, the proceeds distributed would be assessed to the beneficiary under subsection 99B(1) and the remainder would not be.*

Example 5 – settled sums and gifted assets

46. *A non-resident trust was established in 1995 and the initial settled property of the non-resident trust was land and cash. In 2000, the trust estate was gifted a residential property.*

47. *The trustee decides to dispose of the land and residential property. The trustee then distributes the proceeds from those disposals to a resident beneficiary.*

48. *For the purposes of the hypothetical resident taxpayer tests, the cost base of the land and residential property (as determined under Divisions 110 and 112 of the ITAA 1997) are relevant and will be the market value of those assets on the date of their acquisition by the trust estate.*

49. *The hypothetical resident taxpayer tests will operate to ensure that the amount of the distribution which is attributable to the capital gain will be included in the assessable income of the beneficiary under subsection 99B(1).*

Source of the distribution

50. The identification of the cost base of a CGT asset which the trustee disposed of is not conclusive of the operation of the hypothetical resident taxpayer tests or of that amount being removed from the operation of subsection 99B(1).

51. Paragraphs 99B(2)(a) and (b) require a determination of what the relevant amount received by the beneficiary represents and is attributable to. That may require looking beyond the asset distributed (or sold and the proceeds distributed) by the trustee. If a trustee acquires a CGT asset with amounts representing trust income not previously subject to tax in Australia, the amount received by the beneficiary may still represent or be attributable to amounts which would be included in the assessable income of the hypothetical taxpayer. The hypothetical resident taxpayer test requires determination of what the amount ultimately represents, which involves tracing through to determine the source of the amount.

Example 6 – capital asset acquired using interest income

52. *In the income year ending 30 June 2000, a non-resident trust derived a substantial sum of interest income from a lending arrangement. On 1 September 2001, it used $350,000 of that income to acquire a CGT asset. The trust estate later disposed of the CGT asset on 15 July 2010 for $300,000. On 30 June 2015, the non-resident trust estate distributed $300,000 attributable to those proceeds to a resident beneficiary.*

53. *For the purposes of the hypothetical resident taxpayer tests, in determining whether the amount received by the beneficiary represents or is attributable to an amount which would be assessed to a hypothetical resident, the source of the distribution needs to be identified.*

54. *The proceeds from the sale of the CGT asset would not have been assessable to a hypothetical taxpayer (as the asset was realised at a loss), but the asset was acquired using interest income which would ordinarily be assessable income of a resident taxpayer. The distribution, in that sense, represents and is attributable to an amount which would be assessable to a hypothetical taxpayer. Accordingly, it would be assessed under subsection 99B(1) in the hands of the resident beneficiary.*

Status: **draft only – for comment**

Appendix 2 – Your comments

55. You are invited to comment on this draft Determination. Please forward your comments to the contact officer by the due date.

56. A compendium of comments is prepared when finalising this Determination, and an edited version (names and identifying information removed) is published to our Legal database on ato.gov.au

57. Please advise if you do not want your comments included in the edited version of the compendium.

Due date: 28 August 2024

Contact officer details have been removed as the comments period has ended.

References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 2006/10, TD 2017/24

Legislative references:

- ITAA 1936 99B
- ITAA 1936 99B(1)
- ITAA 1936 99B(2)
- ITAA 1936 99B(2)(a)
- ITAA 1936 99B(2)(b)
- ITAA 1936 99C
- ITAA 1936 102AAM
- ITAA 1997 Part 3-1
- ITAA 1997 104-10
- ITAA 1997 Div 110
- ITAA 1997 Div 112
- ITAA 1997 DIV 115
- ITAA 1997 118-20
- ITAA 1997 Div 128
- ITAA 1997 128-15(4)

Cases relied on:

- Howard v Commissioner of Taxation (No 2) [2011] FCA 1421; 2011 ATC 20-298; 86 ATR 753;
- Howard v Commissioner of Taxation [2012] FCAFC 149; 206 FCR 329; 2012 ATC 20-355; 91 ATR 89
- Union Fidelity Trustee Co (Aust) Ltd v Commissioner Of Taxation (Cth) [1969] HCA 36; 119 CLR 177; 69 ATC 4084; 1 ATR 200; 43 ALJR 313

Other references:

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ATO references

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