PS LA 2010/1 - Approach to cases involving Division 6 of Part III of the Income Tax Assessment Act 1936

Australian Government
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Practice Statement Law Administration

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This practice statement is issued under the authority of the Commissioner of Taxation and must be read in conjunction with Law Administration Practice Statement PS LA 1998/1. It must be followed by Tax Office staff unless doing so creates unintended consequences or is considered incorrect. Where this occurs Tax Office staff must follow their business line's escalation process.

SUBJECT: **Approach to cases involving Division 6 of Part III of the *Income Tax Assessment Act 1936***

PURPOSE: **To advise staff of the approach to be taken in respect of compliance activities (including assessments, administrative penalties and interest charges), rulings, objections and appeals involving Division 6**

TABLE OF CONTENTS	**Paragraph**

BACKGROUND

1. Under section 97 of the *Income Tax Assessment Act 1936* (ITAA 1936),[1] a beneficiary who is presently entitled to a share of the 'income of the trust estate' is assessed on 'that share' of the trust's notional taxable income worked out under section 95. That notional taxable income is referred to as the 'net income' of the trust estate, but to avoid confusion in this practice statement it is referred to as the '[tax] net income'.

[1] All subsequent legislative references are to the ITAA 1936 unless indicated otherwise.

2. The meaning of the expressions 'income of the trust estate' and 'share' were considered by the High Court in its decision in *Commissioner of Taxation v. Phillip Bamford & Ors; Phillip Bamford & Anor v. Commissioner of Taxation* (*Bamford*) [2010] HCA 10.

3. Following the decision it is clear that 'income of the trust estate' takes its meaning from trust law such that, if the deed permits, capital receipts of a period can be treated as income for that period. It is also clear that a beneficiary's share of the income of the trust estate available for distribution (that is, of the trust's 'distributable income') is converted to a percentage and the beneficiary is assessed on that same percentage of the trust's [tax] net income.

4. The Commissioner's view of the decision in *Bamford* is contained in the Decision Impact Statement for that case. That statement acknowledges that considerable uncertainty remains about the application of Division 6 of Part III (Division 6) (particularly in respect of factual circumstances that are different from those in *Bamford*).

5. The Commissioner, in consultation with practitioners, intends to develop further guidance on the operation of Division 6.

STATEMENT

Notification and other requirements

6. Given the ongoing uncertainty about the meaning of the expression 'income of the trust estate' as used in Division 6 (and, in particular, in section 97), staff must notify the SME Trust Risk Manager of any private ruling, audit, objection or litigation case that involves the assessment of the [tax] net income of a trust. Notifications must be made by emailing Trust Risk Manager@ato.gov.au. The notice should be given as soon as the case is identified as one which involves, directly or indirectly, the application of Division 6.

7. This notification process is designed to ensure that the trust assessing provisions are applied consistently. The requirement to notify the Trust Risk Manger is in addition to any other BSL escalation practice.

8. No case should be resolved without a detailed consideration of the trust deed (including any amendments that have been made to it) and all relevant documents including (but not limited to) relevant trustee resolutions and financial statements. Staff should request this information if it has not previously been provided.

9. In particular, staff undertaking active compliance activities should not, in the usual course, seek to rely upon a distribution statement contained in a trust's tax return as the sole basis for determining who should be assessed on the trust's [tax] net income.

Compliance action

10. Because there had been considerable uncertainty before the decision in *Bamford* about the principles applicable to the operation of Division 6, it may be expected that some taxpayers will have lodged tax returns and / or administered their trusts on the basis of views that, with the benefit of the decision in *Bamford,* may be seen to be wrong. Accordingly, staff undertaking active compliance activities in respect of the 2009-10 and earlier income years should not select cases for active compliance just to correct such errors. However, if there is a deliberate attempt to exploit Division 6 (see paragraph 11 of the practice statement) or cases are selected for other reasons (for example, because there is a dispute about the quantum of the [tax] net income), and adjustments are to be made, the adjustments must be made on the basis of the law as explained in *Bamford*.

Deliberate attempts to exploit Division 6

11. Staff should be alert to, and continue to identify, arrangements in respect of any income year that seek to avoid some or all of the liability in respect of the [tax] net income of a trust. For example where:

- there is a deliberate mismatch between the beneficiaries' entitlements and the tax outcomes with the result that some or all of the tax liability in respect of the trust's [tax] net income is avoided (see Example 1)
- there are reasonable arguments to suggest that Part IVA, or a specific anti-avoidance or integrity provision such as section 100A (aimed at trust stripping schemes), may apply to alter the way the [tax] net income is allocated between the trustee and the beneficiaries (see Example 2), or
- it is reasonably arguable, on the facts of the case that aspects of the arrangement that affect the application of Division 6 are a sham or of no legal effect (like the purported resolutions to appoint income to a loss trust that were disregarded in *Raftland v. Commissioner of Taxation* [2008] HCA 21; 68 ATR 170; [2008] ATC 20-029).

Example 1

12. *In a particular year the trustee of a family trust derives $250,000 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 power upon the trustee to characterise receipts and outgoings as on income or capital account.*

13. *In the relevant year one of the discretionary objects is in a loss position for tax purposes.*

14. *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.*

15. *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 [tax] net income of the trust is assessable to the loss beneficiary. This would have the result that the [tax] net income of the trust would be free of tax.*

16. *The contended result involves a clear mismatch between the loss beneficiary's entitlements and the tax outcomes; all of the [tax] net income is assessed to the loss beneficiary but the bulk of the income is accumulated.*

17. *Staff should select an arrangement of this kind for closer scrutiny and possible action. Issues arising under this arrangement might include whether the purchase of the holiday home is an expense or outgoing of the trust such as should be taken into account in ascertaining the distributable income of the trust or whether it is simply an accumulation of that income such as may attract the operation of section 99A or, alternatively, whether there is potential for the application of Part IVA.*

Example 2

18. *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 receipts and outgoings are on income or capital account.*

19. *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 beneficiaries of the 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.*

20. *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 section 97 purposes, so all of the [tax] net income of the trust is to be attributed to the charity. This would result in the [tax] net income of the trust being free of tax.*

21. *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.*

22. *The facts of this example are such as to raise questions as to the tax effect of recharacterising as capital what was otherwise received as income and, alternatively, as to whether the arrangement might attract the operation of Part IVA. Staff should select an arrangement of this kind for closer scrutiny and possible action.*

23. *Moreover, an issue arises as to whether the trustee was authorised, under the trust deed, to recharacterise what was clearly an income receipt as capital. That is, staff would examine (in light of the settlor's intention to distinguish between those beneficiaries to whom income and capital could be appointed) whether the seemingly broad power to recharacterise receipts was any more than an administrative power to honestly classify receipts according to law). See in this regard the Decision Impact Statement published in respect of Forrest v. Commissioner of Taxation [2010] FCAFC 6.*

Private rulings, objections and appeals

24. Any private ruling, objection decision or argument in appeal must of course be based on the Commissioner's view of 'income of the trust estate' and 'that share'.

25. In that regard, staff should refer to the *Bamford* Decision Impact Statement. The Decision Impact Statement notes that some public rulings that may be relevant to the operation of Division 6 will be withdrawn with effect from the 2010-11 and later income years. Further public rulings may issue. Staff should follow the usual procedures in identifying the relevant precedential ATO view.

26. Although taxpayers were able to self assess in accordance with Law Administration Practice Statement PS LA 2005/1 (GA) – about trust capital gains for income years prior to 2010-11, staff must apply the ATO view of the law if the assessment of the trust net income arises in a dispute.

27. That is not to preclude, however, the possibility that PS LA 2005/1 (GA) might provide a reasonable basis for settling a tax dispute with a trustee and/or beneficiaries in respect of the 2009-10 or earlier income year. All settlements must be made in accordance with the Commissioner's Code of Settlement Practice.

Assessments

28. In actioning active compliance cases in accordance with this practice statement, staff should raise alternative assessments against beneficiaries and / or the trustee, where, because of different views of the facts, there is genuine doubt about which assessment is appropriate. For example, if there are two interpretations clearly open as to the effect of a particular trustee resolution, and on one interpretation a share of the trust's [tax] net income is appropriately assessed to the trustee and on another interpretation it is assessed to beneficiaries, then it would be appropriate to issue assessments in respect of that share to both the trustee and the relevant beneficiaries.

29. Alternative assessments may also be necessary and appropriate in a case that raises issues of uncertainty that were not addressed or resolved by the *Bamford* decision.

30. Any recovery action would be in relation to the primary assessment only.

31. Law Administration Practice Statement PS LA 2006/7 and the *ATO Receivables Policy* contain more information about alternative assessments.

32. If making a trustee assessment, staff should apply the Commissioner's administrative practice that applies to income years ended 30 June 2005 (or later substituted accounting period) and later income years. Under that practice, an original assessment will only be made within four years from the later of the due date for lodgment of the trust return or the actual lodgment date of the return, except where there has been fraud or evasion.

Administrative penalty and interest charges

33. In the absence of a tax avoidance scheme, staff should accept that trustees and beneficiaries who have prepared returns for the 2009-10 or earlier income years on the basis of the Commissioner's views of the operation of Division 6 (as argued in *Bamford*), or on the basis of an alternative view about the operation of Division 6 that is reasonably open having regard to other relevant authorities, have taken 'reasonable care to comply with the taxation law' and that their position is 'reasonably arguable' for the purposes of Division 284 of Schedule 1 to the *Taxation Administration Act 1953* (TAA). In these circumstances there will be no liability for administrative penalty in respect of a relevant 'shortfall amount' (or part thereof).

34. Similarly, and in accordance with Law Administration Practice Statement PS LA 2006/8, the factors mentioned in the paragraph above should be taken into account when determining whether it is fair and reasonable for the Commissioner to remit any shortfall interest charge or general interest charge imposed under the ITAA 1936 and/or the TAA.

EXPLANATION

35. The [tax] net income of a trust for an income year is calculated in accordance with section 95. The [tax] net income is assessed to beneficiaries and/or the trustee in accordance with Division 6 (in particular sections 97, 98, 98A, 99, 99A).

36. Section 97 provides that a beneficiary who is ‘presently entitled to a share of the income of the trust estate’ is to be assessed on ‘that share’ of the [tax] net income of the trust estate. Section 98 assesses the trustee on behalf of a beneficiary on the beneficiary’s share of the [tax] net income where the beneficiary is under a legal disability or is a non-resident at year end.

37. Sections 99 and 99A provide for the trustee to be assessed where there is any part of the [tax] net income of the trust that is not assessed to a beneficiary under section 97, to the trustee on behalf of a beneficiary under section 98, or that ‘represents income’ to which a beneficiary is presently entitled and that is attributable to a period when the beneficiary was not a resident and is also attributable to sources out of Australia.

38. The Commissioner previously took the view that

- ‘income of the trust estate’ is that which is ordinary income in the hands of the trustee
- the words ‘that share’ refer to the beneficiary’s proportionate or fractional entitlement to so much of the ‘income of the trust estate’ that has been distributed or that remains available for distribution at the end of the year after the trustee has made provision for the proper revenue outgoings of the trust
- for these purposes, neither the provisions of a trust deed nor a determination by a trustee acting under authority of a trust deed can alter the character of receipts or outgoings in the hands of the trustee, and
- provisions of a trust deed (and or determinations made by a trustee under authority of a trust deed) that govern what is to be treated as income and what is to be treated as capital for the purposes of apportioning receipts and outgoings between those entitled to income and those entitled to capital *will* affect the question of who is presently entitled to that which was ordinary income in the hands of the trustee.

39. In *Bamford*, the High Court found that a trustee resolution, made pursuant to a power in the trust instrument, to treat a capital receipt as income was effective to treat the capital receipt as 'income of the trust estate' for the purposes of section 97. The Court also found that the words 'that share' refer to the beneficiary's 'proportionate' or 'fractional' interest in the 'income of the trust estate' with the consequence that a beneficiary is to be assessed on that same ‘share’ or proportion of the trust’s [tax] net income.

40. Law Administration Practice Statement PS LA 2009/7 set out the approaches that staff were to adopt in relation the application to the application of Division 6 pending the resolution of the *Bamford* litigation. PS LA 2009/7 is replaced by this practice statement.

Subject references	Trusts, income, share, net income, trust estate, presently entitled
Legislative references	ITAA 1936 ITAA 1936 Part III Division 6 ITAA 1936 95 ITAA 1936 97 ITAA 1936 98 ITAA 1936 98A ITAA 1936 99 ITAA 1936 99A ITAA 1936 100A ITAA 1936 Part IVA TAA 1953 TAA 1953 Sch 1 Division 284
Related public rulings	
Related practice statements	PS LA 1998/1 PS LA 2006/7 PS LA 2006/8 PS LA 2009/7 [replaced by this Practice Statement]
Case references	*Commissioner of Taxation v. Phillip Bamford & Ors; Phillip; Bamford & Anor v. Commissioner of Taxation* [2010] HCA 10 *Forrest v. Commissioner of Taxation* [2010] FCAFC 6 *Raftland v. Commissioner of Taxation* [2008] HCA 21; 68 ATR 170; [2008] ATC 20-029
Other references	ATO Receivables Policy Decision Impact Statement [Bamford] Decision Impact Statement [Forrest]
File references	1-1ODONHM
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Other Business Lines consulted	