PS LA 2010/1 - Approach to cases involving Division 6 (trust income) of the Income Tax Assessment Act 1936

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Approach to cases involving Division 6 (trust income) of the *Income Tax Assessment Act 1936*

This Practice Statement sets out how to approach compliance activities involving Division 6 (trust income) of the *Income Tax Assessment Act 1936*.

This Practice Statement is an internal ATO document and an instruction to ATO staff.

If taxpayers rely on this Practice Statement, they will be protected from interest and penalties in the following way. If a statement turns out to be incorrect and taxpayers underpay their tax as a result, they will not have to pay a penalty, nor will they have to pay interest on the underpayment provided they reasonably relied on this Practice Statement in good faith. However, even if they do not have to pay a penalty or interest, taxpayers will have to pay the correct amount of tax provided the time limits under the law allow it.

1. What this Practice Statement is about

This Practice Statement provides guidance on how to approach compliance activities involving Division 6 of Part III (trust income) of the *Income Tax Assessment Act 1936*, particularly in the light of the High Court decision in *Commissioner of Taxation v Bamford* [2010] HCA 10 (*Bamford)*.

This Practice Statement replaces Law Administration Practice Statement PS LA 2009/7 (withdrawn) *Approach to certain trust issues involving Division 6 of Part III of the Income Tax Assessment Act 1936 pending resolution of the Bamford litigation*, which applies to the pre-*Bamford* situation.

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

2. Relevant legislation

Under section 97, 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. However, to avoid confusion, in this Practice Statement it is referred to as the '[tax] net income'.

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

3. The *Bamford* decision

In considering the meanings to be given to 'income of the trust estate' and 'share', the High Court found in *Bamford* 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
- a beneficiary's share of the income of the trust estate is converted to a percentage and the beneficiary is assessed on that percentage of the trust's [tax] net income
- a trustee resolution, made under 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.

4. Post-*Bamford*

Since the *Bamford* decision, there have been a number of judicial decisions relevant to assessing the [tax] net income of a trust.

Important judicial decisions include:

- *Colonial First State Investments Limited v Commissioner of Taxation* [2011] FCA 16, which deals with a number of matters relevant to ascertaining how the tax law applies to trusts, and
- *Commissioner of Taxation v Greenhatch* [2012] FCAFC 84, which provides that streaming of capital gains for trust law purposes does not necessarily cause a corresponding income tax treatment.

Relevant legislative changes have also been introduced.[1] For income years ended 30 June 2011 and later, where franked distributions and capital gains of a trust are streamed to a taxpayer in a manner prescribed by the tax law, that taxpayer will be assessed on a corresponding amount of franked distributions and capital gains. For the same years, additional integrity provisions may apply where income tax exempt entities are made presently entitled to the income of a trust estate.

We have also developed further documents (and withdrawn some existing documents) that provide guidance on the operation of Division 6. A list of the available guidance documents and those that were withdrawn is contained in section 10 of this Practice Statement.

5. How you should approach trust issues

You must consider in detail the trust deed (including any amendments) and all relevant documents, including (but not limited to) relevant trustee resolutions and financial statements. You should request this information from the taxpayer if it has not been provided.

You should not rely on a distribution statement in a trust's tax return as the sole basis for determining who should be assessed on the trust's [tax] net income.

6. Raising alternative assessments

You should raise alternative assessments against beneficiaries or the trustee where, because of different views of the facts, there is genuine doubt about which assessment is correct. For example, if there are 2 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 properly 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.

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

Law Administration Practice Statements PS LA 2006/7 *Alternative assessments* and PS LA 2011/4 *Collection and recovery of disputed debts* contain more information about alternative assessments.

7. Deliberate attempts to exploit Division 6

You should be alert to arrangements 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 of this Practice Statement)
- 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 Examples 2 and 3 of this Practice Statement)
- 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 Pty Ltd as trustee of the Raftland Trust v Commissioner of Taxation* [2008] HCA 21.

Example 1 – recharacterisation of capital outgoing as being on income account

In a particular year, the trustee of a family trust derives $250,000 income, of which $245,000 is applied to buy a holiday home for the family. The trust deed gives the trustee power to distribute income and capital among a single class of discretionary objects and to characterise receipts and outgoings as on income or capital account.

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

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.

The trustee contends that, as the loss beneficiary is presently entitled to all of the income of the trust for section 97 purposes, all of the [tax] net income of the trust is also assessable to the loss beneficiary. This would have the result that the [tax] net income of the trust would be free of tax.

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[1] The *Tax Laws Amendment (2011 Measures No. 5) Act 2011* was given Royal Assent on 29 June 2011 and has effect from 1 July 2010.

The contended result here 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.

You should closely scrutinise an arrangement of this kind. Issues you need to consider include whether the purchase of the holiday home is an expense or outgoing of the trust that should be taken into account in determining the income of the trust estate, or whether it is simply an accumulation of that income such as may attract the operation of section 99A or, alternatively, whether Part IVA may apply.

Example 2 – recharacterisation of trust income as a capital receipt

In a particular year, the trustee of a family trust derives $100,000 of income. The trust deed has 2 classes of beneficiaries (those entitled to share in income and those entitled to share in the capital) and the membership of these 2 classes is different. The trustee has a discretion to allocate income and capital within the 2 classes of beneficiaries. The deed also gives the trustee a power to determine whether receipts and outgoings are on income or capital account.

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, amends the deed to admit into the class of income beneficiaries of the trust a tax exempt charity, and*
- *determines to characterise $95,000 of the income as a capital receipt for the purposes of the deed.*

The trustee allocates the $5,000 of income to the charity and the remaining $95,000 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, 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.

Before 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.

This example raises questions about the tax effect of recharacterising capital that was otherwise received as income and whether the arrangement might attract the operation of Part IVA.

There is also a question about whether the trustee was authorised, under the trust deed, to recharacterise what was clearly an income receipt as capital. You need to examine (in light of the settlor's intention to distinguish between those beneficiaries to whom income and capital could be allocated) whether the seemingly broad power to recharacterise receipts was any more than an administrative power to honestly classify receipts according to law. In this regard, see the Decision Impact Statement on Forrest v Commissioner of Taxation [2010] FCAFC 6.

If this arrangement occurred in the 2010–11 and later income years, the anti-avoidance rules contained in sections 100AA and 100AB need to be considered as they apply to distributions to an exempt entity. In this example:

- *Section 100AA applies where the trustee does not pay or notify the exempt entity in writing of their present entitlement to the $5,000 within 2 months of the end of the relevant income year. The exempt entity is treated as not being (and never having been) presently entitled to the income of the trust estate to the extent that they were neither notified nor paid the entitlement.*
- *Section 100AB applies as the exempt entity's adjusted Division 6 percentage of 100% exceeds its benchmark percentage of 5%. The adjusted Division 6 percentage is the exempt entity's entitlement to the income of the trust estate (ignoring capital gains or franked distributions to which any beneficiary or trustee is specifically entitled) expressed as a percentage of that income (being $5,000 ÷ $5,000 × 100%). The benchmark percentage is the exempt entity's present entitlement to any amount forming part of the trust's adjusted [tax] net income expressed as a percentage of that income (being $5,000 ÷ $100,000 × 100%). The exempt entity is treated as not being (and never having been) presently entitled to 95% of the income of the trust.*
- *If the trustee neither notified nor paid the exempt entity within the 2 month requirement, section 100AA results in the trustee being assessed and liable to pay tax under section 99A on the $100,000 [tax] net income of the trust. If the trustee did advise or pay the exempt entity within the 2 month requirement, section 100AB results in the trustee being assessed and liable to pay tax under section 99A on $95,000 (being 95% of the $100,000 [tax] net income of the trust).*

Example 3 – exclusion of net capital gain from trust income

In a particular year, the trustee of a family trust derives business income of $10,000 and a net capital gain of $1 million. The trust deed provides the trustee with a power to appoint income and capital among *discretionary objects. It also contains an income equalisation clause that equates income of the trust to section 95 net income unless the trustee otherwise determines.*

Having received advice on effective strategies for minimising tax, and in accordance with the terms of that advice:

- *the trustee exercised a power under the deed, which ensured that the income of the trust estate excluded the net capital gain, and*
- *a corporate beneficiary was specifically incorporated and introduced in the relevant year – the company was a general beneficiary as defined in the deed because of its relationship with other general beneficiaries.*

The trustee appoints the $10,000 of income to the company and the remaining $1 million is appointed, as capital, to a family member who is the controller of the trust and an eligible capital beneficiary. The trustee contends that as the company is presently entitled to all of the income of the trust for section 97 purposes, all of the [tax] net income of the trust is to be attributed to the company. This would result in the [tax] net income of the trust being taxed to the company, which could not pay the resultant tax and would therefore be liquidated.

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.

The facts of this example are such as to raise questions as to the tax effect of the arrangement and, in particular, whether it might attract the operation of section 100A or Part IVA. ATO staff should select an arrangement of this kind for closer scrutiny and possible action.

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8. Seeking advice and assistance

Staff who are uncertain as to the 'income of the trust estate' as used in Division 6 (and, in particular, section 97) for their particular case should escalate their issue to their business line technical leadership and advice area (who may work in conjunction with the Trust Technical Network) for advice and assistance.

9. How you should approach pre-*Bamford* cases

Because there had been considerable uncertainty before the *Bamford* decision about the principles applying to the operation of Division 6, you can expect that some taxpayers will have lodged tax returns and administered their trusts on the basis of views that, with the benefit of the *Bamford* decision, may appear to be wrong. PS LA 2009/7, which has been replaced by this Practice Statement, sets out the approach you would have taken before the *Bamford* decision.

If there is a deliberate attempt to exploit Division 6 (see section 7 of this Practice Statement) or cases are selected for other reasons (for example, because there is a dispute about the amount of the [tax] net income) and adjustments are to be made, they must be made on the basis of the law as it currently stands.

10. More information

For more guidance on trust issues, see

- Decision Impact Statement on *Commissioner of Taxation v Bamford* [2010] HCA 10
- Decision Impact Statement on *Forrest v Commissioner of Taxation* [2010] FCAFC 6
- Law Administration Practice Statement PS LA 2012/2 *Change of trustee*
- Law Administration Practice Statement PS LA 2015/2 *Time limits for trustee assessments*
- PS LA 2009/7 (withdrawn) *Approach to certain trust issues involving Division 6 of Part III of the Income Tax Assessment Act 1936 pending resolution of the Bamford litigation*.

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Part	Comment
Throughout	Content checked for currency and technical accuracy. Updated in line with current ATO style and accessibility requirements.

9 July 2015

Part	Comment
All	Updated to new LAPS format and style.

5 March 2015

Part	Comment
Paragraph 32 & Related practice statements	To include reference to PS LA 2015/2; which now covers the Commissioners administrative practice in relation to trustee assessments.

10 April 2014

Part	Comment
Footnote 4	Updated 'PS CM 2003/05' to CEI 2014/02/03'.
Contact details	Updated.

References

Legislative references	ITAA 1936 Pt III Div 6 ITAA 1936 95 ITAA 1936 97 ITAA 1936 98 ITAA 1936 98A ITAA 1936 99 ITAA 1936 99A ITAA 1936 100A ITAA 1936 100AA ITAA 1936 100AB ITAA 1936 Pt IVA Tax Laws Amendment (2011 Measures No. 5) Act 2011
Case references	Colonial First State Investments Limited v Commissioner of Taxation [2011] FCA 16; 192 FCR 298; 2011 ATC 20-235; 81 ATR 772; [2011] ALMD 4786 Commissioner of Taxation v Bamford [2010] HCA 10; 240 CLR 481; 75 ATR 1; 84 ALJR 266; 264 ALR 436 Commissioner of Taxation v Greenhatch [2012] FCAFC 84; 203 FCR 134; 2012 ATC 20-322; 88 ATR 560; [2013] ALMD 2620 Raftland Pty Ltd as trustee of the Raftland Trust v Commissioner of Taxation [2008] HCA 21; 238 CLR 516; 2008 ATC 20-029; 68 ATR 170; 246 ALR 406
Other references	Decision Impact Statement on Commissioner of Taxation v Bamford [2010] HCA 10 Decision Impact Statement on Forrest v Commissioner of Taxation [2010] FCAFC 6
Related practice statements	PS LA 2006/7 PS LA 2009/7 (withdrawn) PS LA 2011/4 PS LA 2012/2 PS LA 2015/2

ATO references

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