The application of capital gains tax to trusts: Conceptual, technical and practical issues, and a proposal for reform

Ann Kayis-Kumar* and C John Taylor+

Abstract

Trusts are a major (some would say dominant) form of business structure in Australia. Despite, or perhaps because of, their significance longstanding policy, conceptual, technical and practical problems in their tax treatment remain to be resolved.

The variety of types of trust, the differing nature of trust beneficiaries interests, the changing nature of relationships between the trustee, the beneficiary and the trust property throughout the trust lifecycle are some of the general law features which make taxation of trusts problematic. Problems in the tax treatment of trusts are no more evident than in the application of capital gains tax to trusts. The nature of the trust beneficiary's interest in trust assets and the changing nature of that interest in the trust lifecycle raise conceptual and technical issues in taxing capital gains derived through a trust. The fact that income and capital beneficiaries may differ and that a trust must ultimately vest raise policy and technical difficulties as to who should be taxed on a capital gain derived through a trust and when they should be taxed. The existence of capital gains preferences and a policy intent that some of these at least be enjoyed by trust beneficiaries raise technical and practical issues as to how this policy intent can best be achieved.

After tracing the history of Australian legislative provisions and reform proposals dealing with the application of capital gains tax to trusts this paper explores the underlying causes of problems that remain in the application of capital gains tax to trust and proposes legislative solutions to them. Noting that similar problems generally do not exist with the taxation of capital gains derived by companies the paper proposes imposing that capital gains be taxed at the corporate level with distributions to beneficiaries being deductible to the trust and assessable to the beneficiary. The paper examines how this overall model would apply to derivations and distributions capital gains and capital gains preferences at various phases of the trust life cycle in different types of trust.

* Senior Lecturer, School of Taxation and Business Law, Business School, UNSW Sydney

+ Professor, School of Taxation and Business Law, Business School, UNSW Sydney

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1. Introduction

As has been observed trusts play an unusual and significant role in the Australian economy when compared with their use in other common law jurisdictions. More trusts than companies lodge tax returns and, unlike the position in other common law jurisdictions, the use of trusts is not confined to asset protection, charitable entities and deceased estates but extends to the conduct of active business operations. As Cooper has observed trusts are the predominant structure through which retail collective investment is conducted in Australia while trusts, in the property sector in particular, will commonly be used as special purpose vehicles underneath a listed corporate head entity. Finally trusts are the dominant form of business organisation adopted by the small and medium business sector in Australia with discretionary trusts at least forming part of the business structure adopted.[1]

Despite, or perhaps because of, their significance longstanding policy, conceptual, technical and practical problems in the Australian tax treatment of trusts remain to be resolved. This paper begins by outlining the general law features of trusts that make taxation of trusts, and in particular the application of capital gains tax to trusts, problematic. It then traces the history of Australian legislation dealing with the taxation of trusts with particular emphasis being placed on legislation and reform proposals dealing with the application of capital gains tax in the trusts context. The paper then explores the underlying causes of problems that remain in the application of capital gains tax to trusts and proposes legislative solutions to them.

2. The application of capital gains tax in the trusts context

Based as it is on equitable doctrines developed over the centuries the law of trusts is complex and is still largely based on case law. Complexity and conceptual difficulties are evident even when different attempts to define a trust are compared.[2] Given that a trust can be considered as a relationship that exists when certain essential characteristics are present[3] it is unsurprising that trusts can exist in a variety of forms from charitable trusts to fixed trusts to unit trusts to discretionary trusts to resulting and constructive trusts. If a trusts is found to exist where essential characteristics are present it is also unsurprising that trusts can be and are used for a variety of purposes from the administration of deceased estates to the administration of charitable entities to the conduct of small businesses to their use as collective investment vehicles to their use in superannuation funds. With notable exceptions Australian tax law has treated all these different types of trusts and uses of trusts in the same way. Intuitively this practice might be thought to be problematic as involving the adaptation of

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1 See G S Cooper, 'Reforming the Taxation of Trusts: Piecing Together the Mosaic'(2013) 35 Sydney Law Review 187.

2 Compare, for example, the definitions in H A J Ford and W A Lee, *Principles of the Law of Trusts*, 2nd edition, 1990 at [101] with the definition in R P Meagher and W M C Gummow, *Jacobs Law of Trusts in Australia*, 5th ed., 1986 at [101] to [104], with the definition in D J Hayton, *Underhill and Hayton: Law Relating to Trusts and Trustees*, 14th ed., 1987 at p.3, and the definition in G W Keeton, *The Law of Trusts*, 4th ed., 1947 p.3.

3 Meagher and Gummow, above note 2 at [104] (somewhat reluctantly) defined a trust as follows: 'If definition is demanded, then it seems more appropriate to define the trust as the whole relationship which arises between the parties in respect of the property the subject of the trust, and to regard the obligation of the trustee to the beneficiary and the interest of the beneficiary in the property as results flowing from the existence of that relationship.'

concepts developed for and suitable for one type and function of trusts to a different type and use of trusts.

The somewhat indeterminate nature of the trust beneficiary's interest also raises problematic conceptual issues for the application of tax principles to trusts. Here both case law and scholarly comment hold that the nature, and even the existence of, the interest vary according to the type of trust in question, the characteristics of the beneficiary, the stage of administration of the trust, the nature of the trust property and the context in which the question is asked.

For fixed trusts, including unit trusts, prior to the decision of the High Court in *CPT Custodian Pty Ltd v Commissioner of State Revenue (Vic)*[4] authorities had been interpreted as holding that a beneficiary in a fully constituted fixed trust has a proprietary interest, as distinct from a merely a right against the trustee, in all property which for the time being is subject to the trust.[5] *CPT Custodian Pty Ltd v Commissioner of State Revenue (Vic)* distinguished several of the earlier decisions which had been regarded as standing for this proposition and based the question of whether a beneficiary in a unit trust has an interest in trust assets on the degree of nexus between the rights of the beneficiary under the trust deed and the particular asset in question. The result of this analysis was that, in the case of a 'complex unit trust' where the beneficiary only has a right to income net of expenses of the trust fund the beneficiary is not regarded as having ownership of the trust assets for land tax purposes.[6] In the case of discretionary trusts there is authority that the objects of a non-exhaustive discretionary trust, and the objects of an exhaustive discretionary trust in which the class of objects was closed, do not have an interest (for estate duty purposes) in the assets of the trust prior to the exercise of discretion in their favour.[7] In the case of trusts for deceased estates there is authority that, at least for succession and probate duties purposes, has no proprietary interest in any particular asset of the estate during the course of administration.[8]

Still further variations arise when the characteristics of the beneficiary are taken into account. The simplest case is the bare trust where there is a sole *sui juris* beneficiary of a trust where the trustee has no active duties to perform. In this instance there is authority that the beneficiary is absolutely entitled to the trust assets as against the trustee [9] in the sense of having a right to demand and receive payment from the trustee. However, where there are several beneficiaries with concurrent interests it appears that they must join together to direct the trustee to make a distribution to them.[10] There is authority that one of several *sui juris* beneficiaries could make such a direction individually where the assets of the trust are readily divisible (as is the case with the credit balance in a bank account) but not in the case of

4 (2005) 224 CLR 98.

5 See, for example, C J Taylor, *Capital Gains Tax: Business Assets and Entities* citing *Charles v FCT* (1954) 90 CLR 598; *Read v Commonwealth of Australia*, (1988) 167 CLR 57; *Costa and Duppe Properties Pty Ltd v Duppe* [1986] VR 90; *Perpetual Trustee Co v FCT* [1977] 2 NSWLR 472; *New Zealand Insurance Co v Commissioner of Probate Duties* [1973] VR 659

6 See the discussion of this aspect of the decision in *CPT Custodian Pty Ltd v Commissioner of State Revenue (Vic)* (2005) 224 CLR 98 in John Hyde Page, 'CPT Custodian and the effect of trustee recoupment rights on the taxation of beneficiaries' (2011) 40 ATRev 165 at 177 to 178.

7 *Gartside v IRC* [1968] AC 553; *Re Goldsworthy* [1969] VR 843 (non-exhaustive discretionary trust); *Sainbury v IRC* [1970] Ch 712 (exhaustive discretionary trust in which class of objects was closed). *Queensland Trustees Ltd v Commissioner of Stamp Duties (Qld)* (1952) 88 CLR 54 is regarded by some as authority that each object of an exhaustive discretionary trust in which the class of objects is closed has an interest in the trust assets. It is submitted that the better view is that *Queensland Trustees Ltd v Commissioner of Stamp Duties (Qld)* (1952) 88 CLR 54 is not concerned with discretionary trusts at all but with the construction of a gift over in default of appointment with a mere power attached. See the discussion in C J Taylor, *Capital Gains Tax: Business Assets And Entities*, Sydney, 1994 at [11.68] and the discussion in H A J Ford and W A Lee, *Principles of the Law of Trusts,* 2nd ed, Sydney, 1990 at [513].

8 *Commissioner of Stamp Duties (Qld) v Livingston* [1965] AC 694.

9 *Kafataris v FCT* [2011] FCA 1454.

10 *Walsh Bay Developments Pty Ltd v FCT* (1995) 31 ATR 15

indivisible assets (such as land).[11] In the case of a unit trust there is authority that beneficiaries are not necessarily presently entitled to the net income of the trust in a particular accounting period as any rights to payment that the unit holders had would be subject to the trustee's right of exoneration against the trust fund.[12]

Where the interest of a beneficiary is subject to a contingency (such as reaching a particular age) then the beneficiary has no interest in the trust until the contingency is satisfied. This situation is to be distinguished from one where the beneficiary has an interest in the trust but payment to the beneficiary cannot be made due to the beneficiary being under a legal disability and hence incapable of giving a good receipt to the trustee. In this instance the beneficiary is regarded as vesting in interest but as not vesting in possession while the beneficiary is under a legal disability. In this situation the fact that the interest of the beneficiary is defeasible (for example by the death of the beneficiary before ceasing to be under a legal disability) does not, of itself, prevent the beneficiary from being vested in interest. The position of successive beneficiaries (such as a life tenant and a remainderman) is analogous. The life tenant is vested in interest and entitled to income and can, subject to preservation of the interest of the remainderman, be entitled to possession but not absolute ownership of assets such as land. The remainderman is vested in interest but is not vested in possession until the interest of the life tenant terminates. Again the fact that the future interest of the remainderman is defeasible does not prevent the remainderman from being vested in interest during the term of the life tenant's interest.

Further differentiation of rights can be found when case law on discretionary trusts is considered. There is authority that *sui juris* objects of a closed class in an exhaustive discretionary trust acting together may direct the trustee to terminate the trust and distribute the trust fund to them or apply it for their benefit.[13] It also follows logically that the sole *sui juris* object of a closed class in an exhaustive discretionary trust can also direct the trustee to terminate the trust and make a distribution.[14] Where the class of objects is not closed then the authorities indicate that *sui juris* objects acting together cannot direct the trustee to terminate the trust and make a distribution to them.[15] In the case of a non-exhaustive discretionary trust *sui juris* objects of a closed class acting together cannot direct the trustee to terminate the trust and make a distribution.[16] The better view is that one of several objects of a discretionary trust, acting alone, can never be entitled to require the trustee to terminate the trust and make a distribution.[17]

It should be evident from the discussion above that the relationship between the beneficiary and the trustee and the trust property within the one trust can change over time depending on but not limited to: the number of beneficiaries; their legal capacity; the presence or absence of collective action by beneficiaries; the satisfaction of contingencies; the defeasibility or otherwise of their interests; the termination of prior interests; and the actions of the trustee (for example, the exercise of a discretion).

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11 *Stephenson v Barclay's Bank Trust Co Ltd* (1974) 50 TC 374.

12 *Pearson v FCT* [2006] FCAFC 111 citing the High Court decision in *CPT Custodian Pty Ltd v Commissioner of State Revenue* (2005) 60 ATR 371.

13 *Re Smith* [1928] Ch 915.

14 See the argument to this effect in C J Taylor, above n 2 at [11.62].

15 *Re Trafford's Settlement* [1985] 1 Ch 32 (distinguishing *Re Nelson (Note)* [1928] Ch 920; and *Re Weir's Settlement Trusts* [1971] Ch 145.

16 *Re Smith* [1928] Ch 915 per Romer J at 918.

17 For detailed argument on this issue see C J Taylor, above n2 at [11.62] and the discussion in Ford and Lee, above n2 at [513]. Compare the discussion in Y F R Grbich, 'The Mechanics of Discretionary Trust' in Y F R Grbich, G D Munn and H Reicher, *Modern Trusts And Taxation*, Clayton, Victoria, 1978 at 29-30.

The nature of the trust relationship and of the beneficiary's interest also have implications for the effect of dealings by the trustee with trust property and for the effect of distributions by the trustee of trust assets *in specie* or of the proceeds of realisation of trust assets. As a trust is not a separate legal entity but is rather a set of obligations attached to the ownership of assets there is authority that trust assets or the proceeds of trust assets when distributed to beneficiaries have the same character as they had in the hands of the trustee.[18]

As one of the key historic uses of trusts was to allow life tenants to have access to the income of a trust estate while preserving the trust estate itself for the remainderman trust law needed to develop or adopt a concept of income. While the concept of income under tax law was the 'ordinary concept of income' there were not significant differences between that and the concept of 'trust income'. As will be argued below, Australia's basic approach to the taxation of trusts developed in this period. Adjustments to the concept of income for tax law purposes, however, meant that, in the absence of definitions in the deed aligning the two, significant differences between the concepts emerged. The extension of the Australian income tax base by the introduction of a general capital gains tax in 1985 resulted in what is arguably the most significant difference between the two concepts.

The general law characteristics of trusts discussed above inevitably mean that the application of tax law to them will involve difficult conceptual and technical problems particularly given the variety of uses to which trusts are currently put in Australia. At least this will be so where the tax law attempts to mirror the general law.

The problems are particularly evident and difficult when capital gains tax is applied to trusts. Capital gains tax involves (among other things): identifying assets; identifying transactions that produce capital receipts; taxing according to where the beneficial gain arises; applying concessions; determining cost; and determining proceeds. Most, if not all, of these actions will be problematic in the trust context when tax law fully respects and is based upon the general law of trusts. The fact that a general capital gains tax was 'grafted' onto the existing Australian income tax meant that these problems were exacerbated by the need to reconcile the taxation treatment of capital gains derived by a trust and flowing through a trust to beneficiaries with the existing approach to tax income derived through a trust.

3. Historical development of Australian legislation dealing with the taxation of trusts

Prior literature has discussed the history of the provisions in the Commonwealth Income Tax dealing with the taxation of trusts.[19] This account will be confined to the more significant developments that are relevant to the problem of taxing capital gains flowing through trusts and to the solution to the problem proposed in this paper.

The *Income Tax Assessment Act* 1915 taxed trustees at the trustee level as separate taxpayers[20] but allowed a deduction from tax payable by the trustee that was proportionate to the amount of income distributed to beneficiaries.[21] As Slater has observed the approach to

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18 *FCT v Totledge Pty Ltd* (1982) 12 ATR 830, 838 (Bowen CJ, Deane and Fitzgerald JJ).

19 See A H Slater, 'Taxing trust income after Bamford's case' (2011) 40 AT Rev 69 contains a general discussion of the history of the development of what was to become *Income Tax Assessment Act* 1936 Division 6. A Evans, 'The legislative origin of present entitlement in Australia' (2011) 40 AT Rev 235 contains a more detailed account of the origins of the concept of present entitlement. A Evans, 'Dispelling the urban myth around s95A(2)' (2012) 41 AT Rev 173 discusses archival evidence relating to the background behind the introduction of *ITAA* 1936 s95A(2).

20 *Income Tax Assessment Act* 1915 (Cth) s26(1) provided (*inter alia*): 'Any person who derives income as a trustee shall be assessed and liable in respect of income tax as if be were beneficially entitled to the income'.

21 *Income Tax Assessment Act* 1915 (Cth) s27(2) provided: '(2.) In the assessment of a trustee, there shall be deducted from the tax assessable to him so much of the total tax as bears to the total tax the proportion which that part (if any) of the whole income, which is distributed to the beneficiaries, bears to the whole income.'

taxing trusts taken in 1915 avoided difficulties that had been encountered in State legislation in taxing trust income.[22] While the explanatory materials make reference to distinguishing surplus wealth from capital, it is instructive to note that there is no mention of trusts in this context. This is reflective of the manner of production being conducted predominantly through companies.[23]

Beneficiaries were taxed on beneficial interests in trust income derived with no reference being made to a concept of 'present entitlement'.[24] The concept of present entitlement was introduced by amendments in 1918 along with corresponding amendments to the taxation of partnership income. As Evans has shown the 1918 amendments to the taxation of trusts were influenced by the corresponding Victorian legislation which had been developed in response to problems that were perceived to have arisen in case law on colonial income taxes.[25] The 1918 amendments moved from a model of taxing the trust or partnership and then taxing the beneficiary or partners on actual distribution with double taxation being prevented by allowing the trustee or partnership a rebate of tax proportionate to the amount of income distributed. The approach taken in the 1918 amendments was for liability for tax to be entirely at the partner level and for primary liability to be at the beneficiary level with the trustee only being liable where no beneficiary was presently entitled.[26] The second reading speech of the minister introducing *Income Tax Assessment Bill* 1918 pointed out that the approach to taxing partnerships and trusts in the 1915 legislation 'had worked inequitably in many cases'.[27] Based on reports of the Conference of the Taxation Officers of the Commonwealth and States of March 1917 Evans argues that the principal inequity related to taxation of the aggregated income of a partnership without any deductions and that taxpayers who were partners in partnership presumably thought that this was unfair.[28] With respect, however, this analysis appears to be based on a misreading of the overall operation of the 1915 Act in relation to partnerships. Subsection 25(1) of *Income Tax Assessment Act* 1915 provided:

> 'Partners shall be assessed and liable in respect of the income derived by them as partners as if it had been derived by a single person, without regard to the respective interests therein or to any deductions to which any of them may be entitled under this Act, and without taking into account any income derived by any one of them separately or as partner with any other person.'

It is submitted that the effect of this provision was to deny individual partners deductions for expenses incurred at the individual level but not to deny the partnership deductions for

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22 The state-level legislation was narrow in scope and presented a number of difficulties in practice, namely: in determining whether the liability fell primarily on the trustee or the beneficiary; the proper treatment of income directed to be accumulated; whether tax was payable at the rates applicable to the beneficiaries on their individual shares of the income or at the rate applicable to a single income in the hands of the trustee; whether income exempt if received by a non-resident was taxable by reason of being received by a resident trustee for, and paid to, the non-resident; and, whether income derived by a beneficiary as his share of the income arising from a business carried on by the trustees was income from personal exertion or income from property: Slater, above note 18 at 70.

23 "*I invite the close attention of honorable members to these matters, because, if the basis of our scheme of taxation be wrong, the superstructure must fall. It may be regarded as axiomatic that to tax wealth used for the production of more wealth reduces the productivity of the country by diminishing its capital … One of the basic principles of this Bill, then, is the taxation of surplus wealth as distinguished from capital. In my opinion, the principle is sound. It is consistent with the manner in which production is carried on in these days. Modern production is conducted largely, if not mainly, through the agency of companies.*": Australian Government, *Parliamentary Debates*, House of Representatives, 18 August 1915, 5845 (William Morris Hughes).

24 *Income Tax Assessment Act* 1915 (Cth) s14(c).

25 Evans, above note 18 at 249 – 250.

26 *Income Tax Assessment Act* 1915 (Cth) s26 as amended by *Income Tax Assessment Act* 1918 (Cth).

27 House of Representatives, *Parliamentary Debates*, First Reading of *Income Tax Assessment Bill 1915-1918* (Cth), W Watt, Member for Balaclava and Acting Prime Minister and Treasurer (10 April 1918) at p.4258.

28 Evans, above note 18 at 251.

expenses incurred in gaining or producing the partnership income subject to the aggregated assessment. Under the 1915 Act tax was levied on 'taxable income'.[29] Section 18 of the 1915 Act was the progenitor of *Income Tax Assessment Act* 1997 s8-1 and provided (*inter alia*):

> 'In calculating the taxable income of a taxpayer the total income derived by the taxpayer from all sources in Australia shall be taken as a basis, and from it there shall be deducted-
>
> (a) all losses and outgoings, including commission, discount, travelling expenses, interest, and expenses actually incurred in Australia in gaining or producing the gross income'

So when partners were assessed and liable to tax as if they were a single individual they could only be assessed on 'taxable income' which would take into account deductions allowable under s18. This analysis is consistent with the High Court decision in *Leonard v FCT*[30] where a partner was not allowed a deduction at the individual level in respect of his share of the increase in an overall partnership loss that was attributable to the interest paid to him as an external lender. It appears that the overall loss was taken into account as a deduction under *ITAA* 1915 s18(a).[31] In other words the perceived inequity would appear to have been the locking in of losses at the partnership level rather than the denial of deductions at that level. If this were the perceived inequity it was not really resolved in the case of trusts by the 1918 amendments as losses continued to be 'locked in' at the trust level under those amendments. As is well known losses continue to be locked in at the trust level for Australian tax income tax purposes.

The upshot of this analysis is that, in relation to trusts at least, the 1918 amendments were not introduced for particularly good reasons from a tax policy and tax design viewpoint. They were consistent with an overall conduit theory of only taxing those who were beneficially entitled to income. Adopting this approach, however, involved the introduction of more complex drafting modelled on legislation developed in Victoria to avoid problems of taxing income accumulated by a trustee that had arisen with taxing on the basis of beneficial entitlement which did not exist with the 1915 legislation itself. The locking in of losses at the entity level, the principal inequity perceived to exist in the 1915 Act's treatment of partnerships and trusts, was resolved for partnerships by the 1918 amendments but continued to exist in relation to trusts.

The approach taken in the 1918 amendments was continued in the 1922 *Income Tax Assessment Act* and despite changes in the structure and in some terminology the trigger for the taxation of beneficiaries continued to be 'present entitlement' under Division 6 of *Income Tax Assessment Act* 1936 ('*ITAA* 1936').

If the *ITAA* 1936 was enacted with the intention of removing the confusion around the issue of 'present entitlement', this is not immediately apparent. Further, it is noteworthy that the concept of 'net income' was first introduced in the *ITAA* 1936 (emphasis added). Extracts of the two provisions are as follows:

Section 31(2)(b) of the *ITAA* 1922:	Section 99 of the *ITAA* 1936:

[29] *Income Tax Assessment Act* 1915 (Cth) s10(1).

[30] (1919) 26 CLR 175.

[31] See the analysis of the decision in *FCT v Leonard* to this effect in J Taylor, M Walpole, M Burton, T Ciro and I Murray, *Understanding Taxation Law 2018*, at 14.29. It is conceded that this analysis may be difficult to reconcile with *ITAA* 1915 s21 which allowed a partner to offset losses from one partnership against profits made in another, possibly differently constituted, partnership. It may be that this provision was regarded as a specific exception to the general rule for the application of losses in a partnership.

be separately assessed and liable to pay tax in respect of that part of the income of the trust estate which if ***the trustee were liable to pay tax in respect of the income of the trust estate****, would have been the income of the trust estate remaining after allowing all the deductions under this Act, except the deduction under section twenty-four, and …* *(b) to which no other person is presently entitled and in actual receipt thereof and liable as a taxpayer in respect thereof."*	*"Where there is no beneficiary presently entitled to any part of the income of a trust estate, or where there is a part of that income to which no beneficiary is so entitled,* ***the trustee shall be assessed and liable to pay tax on the net income of the trust estate****, or on that part of that net income as the case may be; as if it were the income of an individual, and were not subject to any deduction other than the statutory exemption."*

Division 6 of the *ITAA* 1936 exemplifies how current trust taxation provisions are historical relics of a time when trusts were used in a personal rather than commercial context, and predate the introduction of the CGT regime.[32] Neither the *ITAA* 1936 nor the *Income Tax Assessment Act 1997* (Cth) ('*ITAA* 1997') provide a coherent approach to the taxation of trusts. As noted by The Hon Chief Justice Robert French AC: "*Coherence within the general law is challenged when traditional rules are applied to new forms of trust not contemplated when those rules were formulated*".[33] For example, section 99B was inserted into the *ITAA* 1936 six years before the introduction of the CGT regime and since that time has never been amended in any way which is referrable to or acknowledges the existence of CGT.[34]

When a general capital gains tax was introduced as *ITAA* 1936 Part IIIA, except in the situation where a beneficiary was absolutely entitled to a trust asset as against the trustee, net capital gains made at the trust level were taken into account in calculating the net income of the trust estate for the purposes of Division 6 of Part III of *ITAA* 1936. Taxation of beneficiaries on net capital gains forming part of the net income of the trust estate then depended on what share, if any, beneficiaries had of the income of the trust estate. Further provisions contained in *ITAA* 1936 Part IIIA Division 6 dealt with the capital gains tax treatment of certain distributions (particularly of tax preferred amounts) by the trustee or with the capital gains treatment of actual or deemed dealings by beneficiaries with their interest in the income or corpus of the trust. For the purposes of this paper the most relevant aspect of the tax treatment of capital gains derived through a trust concerns the interaction referred to above between the capital gains regime and Division 6 of Part III of *ITAA* 1936.[35] An application of either the 'proportions' or 'amounts' view of the construction of Division 6 of Part III in that situation along with the interaction of those provisions with Division 6 of Part IIIA of *ITAA* 1936 was regarded as producing inappropriate results in several circumstances.[36]

The next set of amendments affecting the taxation of capital gains flowing through trusts relevant to this paper was the insertion in 1999 of the original Subdivision 115-C in *ITAA* 1997 following the introduction of CGT discounts and small business discounts. Under those provisions a capital gain component could be included in a beneficiary's assessable income under *ITAA* 1936 s97(1) on the basis of the beneficiary being presently entitled to a share of

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[32] "*The current trust taxation provisions in Division 6 of the ITAA 1936 date back to a time when trusts were generally closely held and often testamentary or discretionary vehicles used in a personal rather than commercial context. The provisions also predate the introduction of CGT. The introduction of CGT meant that discrepancies more commonly arose between what was trust law income and what was net income for tax purposes*": Australian Government, Board of Taxation, (Review of the Tax Arrangements Applying to Managed Investment Trusts, Final Report, August 2009), 9.

[33] Robert French AC, 'Critique and comment: Trusts and statutes' (2015) 39(2) *Melbourne University Law Review* 629, 649.

[34] See further, Russell T, 'Termination of trust interests' (Working Paper presented to the Chatham Tax Discussion Group, June 2018), [56]-[57].

[35] The general application of Part IIIA of *ITAA* 1936 to trusts was outlined and analysed in C J Taylor, *Capital Gains Tax: Business Assets And Entities,* Law Book Company Ltd, Sydney, 1994 at [11.3] to [11.5].

[36] See, for example, the analysis in Taylor, above note 35 at [11.55], [11.56] and [11.67].

the income of the trust estate only for it to then be subtracted under *ITAA* 1997 s115-215(b). The interaction between the original Subdivsion 115-C and *ITAA* 1936 Division 6 of Part III could produce the result that a beneficiary was regarded as deriving and being taxed on extra capital gains which, in fact, the beneficiary might never receive. To preserve the effect of the ordering rules for capital loss offsets Subdivision 115-C provided for the grossing up of extra capital gains that beneficiaries were regarded as deriving prior to them being discounted after capital losses were applied at the beneficiary level. The interaction of those provisions with CGT event E4 was particularly complex.[37]

Over the past 2 decades there have been over sixteen (16) government reviews dealing with both the CGT regime and the taxation of trusts (see Annexure A), and additional promises of major updates and rewrites of the trust taxation provisions. Yet, this area remains in need of substantial reform, as observed by academic commentators[38] and practitioners,[39] and acknowledged by government.[40]

It is submitted that such reform ought to be grounded in the principle of tax neutrality. In this regard, the 'economic benefits' model (the 'EBM') outlined in The Treasury's Policy Options Paper entitled 'Taxing trust income – options for reform'[41] is a notable attempt at deviating from the traditional dependence on trust law concepts and moving to a model that relies on tax law concepts.

Specifically, under the EBM approach:[42]

> "*Tax liabilities in respect of the income and gains of a trust should 'follow the money' in that they should attach to the entities that receive the economic benefits from the trust … the EBM would assess beneficiaries on taxable amounts distributed or allocated to them, with the trustee assessed on any remaining taxable income.*"

This approach was one of two options elaborated upon by The Treasury's Policy Options Paper following the initial Consultation Paper entitled 'Modernising the Taxation of Trust Income – Options for Reform', released in November 2011. These two options aimed to help reduce complexity and uncertainty, while achieving appropriate tax outcomes for users of trusts.[43]

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37 See the discussion in C John Taylor, 'The movement of tax preferences through trusts and the causes of tax law complexity' (2007) 36 ATRev 222.

38 Evans C, 'CGT – Mature Adult or Unruly Adolescent?' (2005) 20() Australian Tax Forum 291, 292-293.

39 "*The principal difficulties with the current system of taxation of trusts are … Interaction between Division 6 and other areas of the tax law. The failure of Division 6 to interact appropriately with tax concepts that have arisen since, such as capital gains tax ("CGT") (including the small business entity rules and the application of the CGT discount), and Division 7A of the ITAA1936 (including the tax treatment of unpaid present entitlements under the trust in favour of a private company) as well as those parts of the tax law that give rise to timing differences between trust recognition and tax recognition (such as controlled foreign company and foreign accumulation fund rules, taxation of financial arrangements, Division 16E of the ITAA1936 and Divisions 40 and 43 of the Income Tax Assessment Act 1997 ("ITAA1997")).*": The Tax Institute, 'Consultation Paper: Modernising the taxation of trust income – options for reform' (15 February 2012), 3. See also, The Law Society of New South Wales Young Lawyers Taxation Law & Business Law Committees, 'Response to Treasury in respect of Consultation Paper titled "Modernising the taxation of trust income – options for reform"' (10 February 2012).

40 See, for example, Government Tax Discussion Paper (Re:think, p 112) in March 2015, "while changes have been made to address some specific issues, wider reform has not occurred and the underlying problems remain".

41 For completeness, this concept was also previously suggested in the context of the Board of Taxation's review of the treatment of income derived by managed investment trusts in 2009.

42 Australian Government, The Treasury, 'Taxing trust income – options for reform' (Policy options paper, October 2012).

43 Australian Government, The Treasury, 'Taxing trust income – options for reform' (Policy options paper, October 2012), 8.

Over 30 submissions were made publicly available in relation to the Consultation Paper, however no submissions are currently available in relation to the Policy Options Paper. As such, a detailed analysis of community views presented through the consultation process on the EBM approach is not possible at present.

Nonetheless, it is possible to include an analysis of the three (3) practitioner publications currently within the public domain released at the same time which make specific reference to the Policy Options Paper; specifically, Clayton Utz, Greenwoods & Freehills and Vincents Chartered Accountants.

Clayton Utz noted that the EBM was Treasury's preferred model, and acknowledged that it would be the "*easiest to administer*".[44] Greenwoods & Freehills made the observation that while the Policy Options Paper had focussed on the small business and household sectors, these rules would also apply to all MITs which did not qualify for the proposed attribution regime.[45]

In terms of critique, Clayton Utz observed that the only "*main concern lies in the trustee tax rate*".[46] This concern was also noted by Greenwoods & Freehills, who stated "*[t]he key to the EBM is the rule which describes what must happen in order of the trustee not to be assessed on any of the taxable income*".[47] It is submitted that this issue could be avoided by instead applying a reduced rate, such as the corporate income tax rate in these instances. In any event, it is likely that there is sufficient flexibility in trust deeds currently used by practitioners which would avoid this concern.

Other issues anticipated by Greenwoods & Freehills were as follows:[48]

i. dealing with how to distribute or allocate taxable income generated by a tax fiction such as franking credits and foreign tax offsets;
ii. cash flow issues arising from timing differences between tax and trust law requirements;
iii. identification and ordering of assessable income, exempt income and trust capital; and
iv. distribution of tax preferred amounts without triggering further tax at the investor level.

The Part 5 of this paper specifically deals with issues 'i' and 'iii' through worked examples. For completeness, the EBM approach was also subsequently criticised by the ATO, who cited the following three concerns:[49]

i. (similarly to the above Greenwoods & Freehills concern) how to distribute or allocate tax fictions such as a TOFA or CFC amount;

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[44] Mark Friezer and John Boyagi, 'Taxing trust income - Government releases Policy Options Paper' (Clayton Utz, 8 November 2012); available at: https://www.claytonutz.com/knowledge/2012/november/taxing-trust-income-government-releases-policy-options-paper.
[45] Chris Colley et al, 'Some Progress on Trust Tax Reform' (Greenwoods & Freehills, Tax Brief, 2 November 2012); available at: http://www.greenwoods.com.au/media/1283/tb-021112_-_some_progess_on_trust_tax_reform.pdf.
[46] Mark Friezer and John Boyagi, 'Taxing trust income - Government releases Policy Options Paper' (Clayton Utz, 8 November 2012); available at: https://www.claytonutz.com/knowledge/2012/november/taxing-trust-income-government-releases-policy-options-paper.
[47] Chris Colley et al, 'Some Progress on Trust Tax Reform' (Greenwoods & Freehills, Tax Brief, 2 November 2012); available at: http://www.greenwoods.com.au/media/1283/tb-021112_-_some_progess_on_trust_tax_reform.pdf, 6.
[48] Chris Colley et al, 'Some Progress on Trust Tax Reform' (Greenwoods & Freehills, Tax Brief, 2 November 2012); available at: http://www.greenwoods.com.au/media/1283/tb-021112_-_some_progess_on_trust_tax_reform.pdf, 5-7.
[49] Andrew Mills, 'Trusts update – What the ATO thinks and why you should care' (The Tax Institute, 46th Western Australia State Convention), 37-38.

ii. anomalies where a trustee does not have sufficient cash to make a distribution to extinguish its own tax liability because cash has been spent on non-deductible expenses or where taxable income otherwise exceeds cash; and
iii. distributions of capital gains through a chain of trusts.

The latter two concerns are beyond the scope of this paper, and will be the subject of subsequent research by the authors.

4. The application of capital gains tax to capital gains derived through trusts following the 2011 amendments

The 2011 amendments to *ITAA* 1997 Sub Div 115-C and to *ITAA* 1936 Div 6 of Part III were in response to the High Court decision in *FCT v Bamford*[50]*.* The decision in FCT v Bamford is authority that:

> (a) a clause in a discretionary trust deed empowering the trustee to determine whether a receipt is or is not to be treated as being on income or capital account was effective for trust law purposes and consequently that a determination pursuant to that clause meant that a capital gain of a trust formed part of the income of the trust estate for the purposes of *ITAA* 1936 Div 6 of Part III;
>
> (b) the meaning of the undefined term 'income of the trust estate' in *ITAA* 136 Div 6 of Part III was to be determined according to the general law of trusts; and
>
> (c) in *ITAA* 1936 s97(1) (and presumably in other provisions in *ITAA* 1936 which adopt the same phraseology) the expressions 'share' and 'that share' have the meaning of 'proportion' rather than 'part', 'portion' or 'amount'.

In *FCT v Bamford* the High Court noted that examples could readily be given of apparent unfairness in the operation of the legislation on either the 'proportions' or 'amounts' constructions of *ITAA* 1936 Division 6 of Part III. Problems with both constructions had long been noted by commentators. The particular problem in relation to capital gains and trusts which the 2011 amendments were directed at providing at least a temporary solution for was whether 'streaming' of capital gains in a current year to particular beneficiaries was possible following the High Court decision. For example, in a situation where income and capital beneficiaries differed and trust income was defined as including capital gains the proportions approach would mean that beneficiaries would be taxed on the same proportion of the net income as represented the proportion of the trust income they received. This would mean that all beneficiaries would be taxed on a proportion of the net capital gains of the trust even though only the capital beneficiaries would be entitled to distributions of the capital gains.

The 2011 amendments were intended to 'ensure that, where permitted by the trust, the capital gains…..of a trust can be effectively streamed for tax purposes to beneficiaries by making them "specifically entitled" to those amounts.'[51] At the same time where the trust had not made particular beneficiaries 'specifically entitled' to capital gains the intention was that the amendments produce 'the same outcome as under the current law'.[52] While retaining the concept of present entitlement for taxation of beneficiaries in relation to trust net income other

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50 (2010) 240 CLR 481.

51 Explanatory Memorandum to *Tax Laws Amendment (2011 Measures No5) Bill 2011* at paragraph 2.1. Similar issues arose with franking credits flowing through trusts. These issues are not discussed in this paper.

52 Explanatory Memorandum to *Tax Laws Amendment (2011 Measures No5) Bill 2011* at paragraph 2.2.

than capital gains to which beneficiaries were 'specifically entitled' the 2011 amendments effectively made specific entitlement to a particular capital gain the new touchstone for taxation of capital gains passing through a trust. As the examples below seek to illustrate the result was a highly complex set of interactions between rules which still produce inappropriate and inequitable results in some circumstances. It is submitted that a root cause of these complexities and inequities the continued practice of basing taxation on concepts of 'entitlement' rather than on actual payment.

Note, that this Subdiv only applies when a beneficiary is specifically entitled to a capital gain. Otherwise the tax liability on the capital gain is allocated under Div 6 of ITAA 1936 as occurred prior to the 2011 amendments.

4.1. Outline of key provisions in Subdivision 115-C and ITAA 1936 Division 6E

A. Application of Subdivision 115-C

For *ITAA* 1997 Subdivision 115-C to apply s115-210(1) requires that a net capital gain is taken into account in calculating the net income of a trust estate under *ITAA* 1936 s95. This will mean that Subdivision 115-C will have no application where the s95 calculation produces a trust loss. Question what the position is when the s95 calculation produces a zero amount.

B. Assessment of beneficiaries

i. ITAA 1997 s115-215 'attribution'

ITAA 1997 s115-215(3) means that Division 102 will apply to a beneficiary for each capital gain of the trust estate as if the beneficiary had:

- Where neither discounts nor the small business 50% reduction applied to the capital gain at the trust level - a capital gain equal to the s115-225(1) amount;
- Where either a discount or the small business 50% reduction (but not both) applied to the capital gain at the trust level – a capital gain equal to twice the s115-225(1) amount;
- Where both a discount and the small business 50% reduction applied to the capital gain at the trust level – a capital gain equal to four times the s115-225(1) amount.

The effect of s115-215 is that beneficiaries can have a share of a capital gain realised at the trust level taken into account at the beneficiary level in determining the beneficiary's net capital gains or net capital losses after the application of discounts or the small business 50% reduction. Note that the trigger for the operation of s115-215 is that there are *capital gains* of the trust estate not *net capital gains* of the trust estate. This seems to follow from the s995-1 definition of 'capital gain' [for each CGT event a capital gain is worked out in the way described in that event]. Nonetheless the calculation of the s115-225(1) amount takes capital losses and discounts into account.

The s115-225(1) amount [note that ss115-225(2) and (3) will be discussed later in these notes]

The s115-225(1) amount will be the product of:

(a) The capital gain calculated at the trust level using the method statement in s102-5(1) [including any discount or small business 50% reduction, note though that the method statement also requires the offset of capital losses];
(b) The beneficiary's share of the capital gain divided by the amount of the capital gain.

ii. Beneficiary's share of a capital gain

A beneficiary's share of a capital gain is determined under s115-227 and will be the sum of:

(a) The amount of the capital gain (as calculated at the trust level) to which the beneficiary is 'specifically entitled'; and
(b) If there is an amount of the capital gain to which no beneficiary is specifically entitled and to which the trustee is not specifically entitled – that amount multiplied by the entity's 'adjusted Division 6 percentage of the income of the trust estate for the relevant income year'

The effect of s1`15-227(b) is that where neither a beneficiary nor the trustee is specifically entitled to a capital gain then the capital gain at the trust level is taxed via the pre 2011 operation of *ITAA* 1936 Division 6 of Part III.

iii. Amount of a capital gain to which a beneficiary is 'specifically entitled'

The amount of a capital gain to which a beneficiary is 'specifically entitled' is determined under s115-228. The amount is calculated using the following formula:

*Capital gain x Share of net financial benefit/Net financial benefit

Capital gain here has the s995-1 meaning and hence will not include capital loss offsets, discounts or small business 50% reductions.

'Net financial benefits' is defined in s115-228(1) as meaning an amount equal to the 'financial benefit that is referable to the capital gain (after the application by the trustee of losses provided this is consistent with the application of capital losses against capital gains in the s102-5(1) method statement.

'share of net financial benefit' is defined in s115-228(1) as meaning an amount equal to the financial benefit that, in accordance with the terms of the trust:

(a) The beneficiary has received, or can reasonably be expected to receive; and
(b) Is referable to the capital gain after the application of trust losses in the manner discussed above;
(c) Is so recorded in the accounts or records of the trust no later than 2 months after the end of the income year

iv. Beneficiary's 'adjusted Division 6 percentage'

Where s115-227(b) applies we need to know what a beneficiary's 'adjusted division 6 percentage' is. A beneficiary's 'adjusted division 6 percentage' is defined in *ITAA* 1936 s95(1) as meaning the entity's 'Division 6 percentage' of the income of the trust estate calculated on the assumption that any capital gain or franked distribution to which any beneficiary or the trustee is specifically entitled were disregarded in calculating the income of the trust estate. .The effect is to exclude capital gains to which a beneficiary or the trustee is specifically entitled, in the sense discussed above, from being amounts which can be included in the beneficiary's assessable income or on which a trustee can be assessed and liable to pay tax under *ITAA* 1936 Part III Division 6.

v. Beneficiary's 'Division 6 percentage'

A beneficiary's 'Division 6 percentage' is also defined in 95(1). A beneficiary has a Division 6 percentage of the income of the trust estate equal to the share (expressed as a percentage) of the income of the trust estate to which the beneficiary is presently entitled. A trustee has a Division 6 percentage of the income of the trust estate equal to the share (expressed as a percentage) of the income of the trust estate to which no beneficiary is presently entitled.

Hence if the income of the trust estate is a zero amount then the trustee's Division 6 percentage will be 100%.

C. Interaction with ITAA 1936 Div 6E

ITAA 1936 s102UW will mean that Division 6E applies (inter alia) where the net income of the trust estate exceeds nil and a net capital gain was (existing after the application of Steps 1 to 4 of the method statement in s102-5(1)) taken into account in calculating the net income of the trust estate. As the net income of trust estate must exceed nil, it follows that Division 6E cannot apply where the net income of the trust estate is a zero amount.

Section 102UX requires that the following assumptions be made in determining the amount to be included in the assessable income of a beneficiary under s97, 98A or s100.

> Under s102UX(2) assume that the income of the trust estate were equal to the Division 6E income of the trust estate;
>
> Under s102UX(3) assume that the net income of the trust estate were equal to the Division 6E net income of the trust estate.
>
> Under s102UX(4) assume that the amount of present entitlement of a beneficiary to the income of the trust estate were equal to the amount of the beneficiary's Division 6E present entitlement to the income of the trust estate.

The 'Division 6E income of the trust estate' is defined in s102UY(2) as the income of the trust estate disregarding the s102UW(b) capital gains, franked distributions and franking credits at the trustee level. The Division 6E income of the trust estate cannot be less than nil. In other words if by disregarding the capital gains and franked distribution there is trust loss then the 'Division 6E income of trust estate' cannot be a negative amount but presumably can be zero.

The 'Division 6E net income of the trust estate' is defined in s102UY(3) as the net income of the trust estate calculated on the assumption that the s102UW capital gains, franked distributions and franking credits at the trust level are disregarded. The Division 6E net income of the trust estate cannot be less than nil. Again it would seem that where disregarding capital gains and franked distributions there is a negative amount that cannot be the 'Division 6E net income of the trust estate' but presumably the 'Division 6E net income of the trust estate' can be a zero amount in these circumstances.

A beneficiary's 'Division 6E present entitlement to the income of the trust estate' is defined in s102UY(4) as being equal to the amount of the beneficiary's present entitlement to the income of the trust estate less:

(a) For each capital gain taken into account via s102UW(b) so much of the beneficiary's share of the capital gain (as defined in *ITAA* 1997 s115-227) as was included in the income of the trust estate;
(b) For each franked distribution taken into account via s102UW(b) so much of the beneficiary's share of the franked distribution (as defined in *ITAA* 1997 s207-55).

In effect what Division 6E does when capital gains accrue to a trust is excise the beneficiary's share of the capital gain from the amount that is included in the assessable income of the beneficiary under *ITAA* 1936 s97, s98A or s100.

4.2. Examples of the operation of Subdivision 115-C and Division 6E

A. EXAMPLE 1

To simplify analysis assume a trust with one beneficiary presently entitled to all income and specifically entitled to all capital gains. Assume to simplify analysis that the beneficiary is not absolutely entitled to any trust assets against the trustee. This would not normally be the case in a bare trust of this nature and would arise in fixed trusts with more than one beneficiary, in unit trusts or in discretionary trusts. Trust deed defines trust income as including capital gain. Trust makes capital gain of $1000 on asset held by trust for less than 12 months. Trust has no capital losses and no other losses and no other income.

Trust level

Trust income		$1000
Net income		$1000 s95(1) *ITAA*
Distribute		$1000

Beneficiary level

Division 6E income s102UY(2)		$ 0
Division 6E net income s102UY(3)		$ 0
Division 6E present entitlement	s102UY(4)	$ 0

Therefore no s97(1) assessment

ITAA 1997 s115-215(3) Div 102 applies as if beneficiary had capital gain equal to s115-225(1) amount. This will be the amount of the capital gain ($1000) x your share of the capital gain/the amount of the capital gain.

Here s115-227(a) applies to determine your share of the capital gain. This will be the share of the capital gain to which the entity is specifically entitled. That takes us to s115-228.

Under s115-228 the share of the capital gain to which the beneficiary is specifically entitled is:

Capital gain x share of net financial benefits/net financial benefits

'Net financial benefit' is defined in s115-228(1) as an amount equal to the financial benefit[53] that is referable to the capital gain after the application of losses (but not discounts) by the trustee. A question arises as to whether the question of referability to the capital gain is determined from the perspective of the trust or from the perspective of the beneficiary. Arguably this should be viewed from the trust perspective although the legislation does not expressly state from which perspective this should be determined.[54] Note that losses are taken into account but that discounts are not. Hence here net financial benefit will be $1000.

Under s115-228(1) 'share of net financial benefit' is the share of the financial benefit that the beneficiary has received and is referable to the capital gain (after allowance of losses but not discounts). Here the beneficiary has received $1000 and that is arguably the beneficiary's share of the net financial benefit.

$1000 x $1000/$1000 = $1000

Therefore the s115-225(1) amount is $1000 x $1000/$1000 = $1000

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53 *ITAA* 1997 s974-160 defines 'financial benefit' as meaning anything of economic value including property and services and anything that the regulations made for the purposes of s974-160(3) provide is a financial benefit.

54 See the discussion in D Boccabella, 'Determining proper taxpayer for a "notional" net capital gain on vesting of a discretionary trust asset is problematic' (2017) 46 Australian Tax Review 193.

Note that even in this simplest of examples reference has to be made to a total of 9 provisions in two Acts and that uncertainty in the operation of the provisions arises from the question of the perspective from which referability of the financial benefit to the capital gain not being expressly stated.

B. EXAMPLE 2

Assume the facts in Example 1 with the variation that the trust held the asset for more than 12 months before disposing of it with the result that the 50% discount was available. Note again that here it is assumed that the definition of 'trust income' includes capital gains without allowing for discounts.

Trust level

Trust income	$ 1000
Net income	$ 500 s95(1) *ITAA*
Distribute	$ 1000

Beneficiary level

Division 6E income s102UY(2)	$ 500
Division 6E net income s102UY(3)	$ 0
Division 6E present entitlement s102UY(4)	$ 500

Section 102UX then requires that in calculating any s97(1) inclusion in income the assumptions be made that: (a) the income of the trust estate was the Division 6E income; (b) that the net income of the trust estate was the Division 6E income; and (c) that the present entitlement of the beneficiary was equal to the Division 6E present entitlement. Here as the Division 6E net income is $0 no amount will be included in beneficiary's assessable income under s97(1).

Under *ITAA* 1997 s115-215(3) Div 102 applies as if beneficiary had capital gain equal to s115-225(1) amount. This will be the amount of the capital gain remaining after applying steps 1 to 4 in s102-5(1) ie $500 x your share of the capital gain/ the amount of the capital gain. Your share of the capital gain is calculated under the combined operation of s115-227(a) and s115-228.

Hence the amount of the capital gain to which the beneficiary is specifically entitled under s115-228 is:

$1000 x $1000/$1000 = $1000

Hence the s115-225(1) amount is

$500 x $1000/$1000 = $500

As the 50% discount took place at the trust level s115-215(3)(b) means this amount is multiplied by two making the amount to which Div 102 applies $1000.

C. EXAMPLE 2.1

Example 2.1 asks the following question: "What would be the result in Example 2 if the trust deed had said that trust income was equal to net income?"

Trust level

Profit on realisation	$ 1000
Trust income	$ 500
Net income s95(1)	$ 500
Distribute	$ 500
Beneficiary level	
Division 6E income s102UY(2)	$ 0
Division 6E net income s102UY(3)	$ 0
Division 6E present entitlement s102UY(4)	$ 0
Therefore no s97(1) assessment	

ITAA 1997 s115-215(3) Div 102 applies as if beneficiary had capital gain equal to s115-225(1) amount. Under the combined operation of s115-227 and s115-228 the end result will be that the s115-225(1) amount is $500 but as the 50% discount took place at the trust level s115-225(3)(b) means this amount is multiplied by two making the amount to which Div 102 applies $1000. The beneficiary would then apply the 50% discount reducing the amout included in assessable income to $500.

But here $500 of profit has been retained at the trust level (due to trust income being defined as being equal to net income which took the discount into account). What happens to this $500? The beneficiary is not specifically entitled to it under s115-228. Note the use of the term 'capital gain' as distinct from 'net capital gain' in the opening words in s115-227(b) and in s115-230. Hence the excess $500 would appear to be covered by those provisions. Can the trustee can elect to be specifically entitled under s115-230 and then be assessed on the capital gain via s99 or s99A and the operation of s115-222. Subsection 115-230(1) indicates that the purpose of s115-230 is so to the trustee can make a choice to be assessed on a capital gain **if no trust property representing the capital gain has been paid or applied for the benefit of the beneficiary or a beneficiary of the trust** (emphasis added). By contrast s115-230(3)(b) sets out one of the conditions to which the trustee's choice is subject as being if, 'trust property representing **all or part of a capital gain has not been paid to or applied for the benefit of a beneficiary** (emphasis added). Subsection 115-230(1) can be read as requiring that no trust property representing a capital gain has been paid to a beneficiary. This requirement would not be met in this example as the discount component has been paid to the beneficiary. On the other hand s115-230(3)(b) can be read as making the choice available if trust property representing part of a capital gain has not been paid to a beneficiary. This requirement would be met in this example as the non-discounted component of the capital gain has not been paid to a beneficiary. Alternatively, s115-230(3) could be read consistently with s115-230(1) if it were read as making the s115-230 choice not available where part of a capital gain has been paid to a beneficiary. The ambiguity in the legislation justifies reference to the Explanatory Memorandum to Tax Laws Amendment (2011 Measures No 5) Bill 2011. The Explanatory Memorandum states that the choice must be made in respect of the whole capital gain.[55] Explanatory Memorandum states that the choice must be made in

[55] Explanatory Memorandum to Tax Laws Amendment (2011 Measures No5) Bill 2011 at paragraph 2.107.

respect of the whole capital gain.[56] It is noteworthy that this clarification regarding the 'whole capital gain' does not feature in the legislation. Nonetheless, under this analysis the choice would not be available to the trustee in this Example. It is worth noting, however, that in these circumstances the trustee should not make the election if it is available as it is arguable that a better result for the beneficiary arises if s115-227(b) applies.

Assuming that the Trustee cannot or does not elect then it seems that s115-227(b) applies and the beneficiary's share of the capital gain will be:

> The amount of the capital gain x the adjusted Division 6 percentage of the income of the trust

For the beneficiary the adjusted Division 6 percentage of the income of the trust estate is calculated by disregarding the amount of the capital gain to which the beneficiary is specifically entitled, namely $500. The problem here is that the provision is trying to determine a percentage by disregarding an amount. Presumably the result is zero.

On the basis that the analysis is that no beneficiary is presently entitled to this amount then the trustee's adjusted Division 6 percentage of the income of the trust estate is calculated by disregarding the amount of the capital gain to which the trustee is specifically entitled [but this can only arise it seems if the trustee elects under s115-230]. If the trustee can and does make the election then the result is zero but in this instance the preconditions for s115-227(b) would not be met. Hence there is no part of the capital gain to which the trustee is specifically entitled. Under the definition of 'Division 6 percentage' in s95 we then need to ask if there is a share of the income of the trust estate to which no beneficiary is presently entitled. If so then the trustee's adjusted Division 6 percentage of the income of the trust estate will be 100%. This cannot be the case here as the $500 excess profit was not income of the trust estate and hence it cannot be income of the trust estate to which no beneficiary was presently entitled. The result would then be that the $500 (in these circumstances) would not be taxed at this point and under trust law would then form part of corpus.

A subsequent distribution of the $500 to the beneficiary (say on termination of the trust) should not be included in the beneficiary's assessable income via *ITAA* 1936 s99B because of s99B(2)(a).[57]

A counterargument is that in such a situation, s99B would be read down so that its application is consistent with the rationale for its introduction. This would be consistent with Justice Hill's obiter dictum in *Traknew Holdings v Commissioner of Taxation*.[58]

The existing uncertainty in this area is exemplified by the Taxation Determination TD 2017/24EC, which includes a compendium of responses to the issues raised by external parties to draft Taxation Determination TD 2016/D5. Specifically, Issue No. 1 notes that:[59]

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56 Explanatory Memorandum to Tax Laws Amendment (2011 Measures No5) Bill 2011 at paragraph 2.107.

57 Reliance on s99B(2)(a) is probably not necessary. The historical background to the introduction of s99B and the Commissioner's practice suggest that its operation should be confined to trusts with foreign source income. The correctness of the Commissioner's approach was confirmed by obiter remarks by Hill J in *Traknew Holdings Pty Ltd v FCT* 91 ATC 4272 at 4284.

58 *Traknew Holdings v Commissioner of Taxation* [1991] FCA 125

59 https://www.ato.gov.au/law/view/view.htm?docid=CTD/TD2017EC24/NAT/ATO/00001&PiT=99991231235958.

> "Hill J in *Traknew Holdings Pty Ltd v. FCT* 91 ATC 4272 noted the purpose and historical context in which section 99B *of the Income Tax Assessment Act 1936* (ITAA 1936) is to be understood. That is, income accumulated offshore in a tax-free form was not subject to tax when distributed to a resident beneficiary. Hill J noted that in some cases, the extreme width of the provision might require it to be read down … Section 99B was never enacted to deal with distribution of capital gains, but was enacted to deal with distributions of foreign-sourced income not previously subject to tax in Australia. Coupled with the principles of statutory construction most recently outlined in *Commissioner of Taxation v. Unit Trend Services Pty Ltd* (2013) 250 CLR 523, the Commissioner's view cannot be sustained."

However, the ATO view is currently articulated as follows:[60]

> "… If section 99B did not apply, the amounts could escape taxation altogether. We consider that the approach in the determination is not inconsistent with the legislative intention behind section 99B. While the section was introduced before the CGT provisions, its focus is on taxing distributions from non-resident trusts that have not been assessed. In *Traknew*, Hill J's comments were dicta, and the factual circumstances under consideration were far removed from those to which section 99B were primarily directed."

If there were, say, two beneficiaries in the trust and they directed the trustee to terminate then, in the case of a fixed trust there would be an operation of CGT Event E5. CGT Event E5 does not apply to unit trusts. As the asset in question is part of the capital proceeds of the sale there can be no capital gain or loss at the trustee level. Subsection 104-75(4) will mean that any capital gain or loss at the beneficiary level is disregarded assuming that the beneficiaries acquired their interests for no expenditure. CGT Event E5 could conceivably apply at a future point in a discretionary trust but again s104-75(4) should mean that capital gains or losses of the beneficiary are disregarded if the beneficiaries acquired their interests for no expenditure. It should be noted though that, depending on the terms of the trust and the type of asset involved the decision in *Oswal v FCT*[61] can mean that the object beneficiary in a discretionary trust will not become absolutely entitled to the asset as against the trustee with the result that CGT Event E5 will not apply.

The same analysis would apply for CGT Event E7. There should be no capital gain at the trustee level and s104-85(6) should mean that any capital gain or loss of the beneficiary will be disregarded where the beneficiaries acquired their interest for no expenditure. As discussed below it is arguable that CGT Event E7 only applies to *in specie* distributions by the trustee to beneficiaries.

Arguably object of a discretionary trust do not have an interest in the trust prior to the exercise of discretion. Once discretion is exercised and an asset is vested in an object the decision in *Oswal v FCT* is that there is an operation of CGT Event E1. The analysis seems to be that this then creates a bare trust in favour of the beneficiary. Depending on the terms of the trust and the nature of the trust assets the beneficiary of the bare trust may or may not be absolutely entitled as against the trustee. If the beneficiary is absolutely entitled as against the trustee then CGT event E5 would operate in the manner discussed in the previous paragraph. There would be no capital gain for the beneficiary where the interest in the trust was acquired for no

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60 https://www.ato.gov.au/law/view/view.htm?docid=CTD/TD2017EC24/NAT/ATO/00001&PiT=99991231235958.

61 (2013) 96 ATR 68

expenditure. Where the asset in question is proceeds of sale there can be no capital gain made by the trustee in vesting the asset in the beneficiary. On the actual distribution *in specie* of the asset (which arguably here could include actual cash) E7 could operate but again there should be no capital gain or loss to the beneficiary where their interest was acquired for no expenditure.

Where the trust is a unit trust Event E5 and E7 cannot be applicable but the operation of CGT event E4 needs to be considered. The better view is that E4 cannot apply to discretionary trusts.[62]

In the case of fixed trusts (other than unit trusts) whether E7 or E4 applies turns on the distinction between a disposal of a CGT asset being 'in satisfaction of the beneficiary's interest of part of it' (CGT Event E7) and a payment being 'in respect of …. your interest in the trust'. This could turn on whether a payment (in the form of say a direct debit or a cheque) in respect of a CGT asset held by the trust in the form of (say) a bank account is itself a disposal of that CGT asset. The decision in *Naval Military and Airforce Club of South Australia*[63] would suggest that it is not as there is not identity between the trust CGT asset and the asset (a credit to a different account) that the beneficiary acquires. Under this analysis CGT Event E7 would be confined to *in specie* distributions to beneficiaries.

Under CGT Event E4 s104-70(4) will produce a capital gain if the 'sum of the non-assessable parts of the payments ….in respect of …..the unit or interest is more than its cost base'. Under Item 1 in the Table in s104-71(4) a distribution of the discount component will be excluded from the non-assessable part referred to in s104-70. Hence the payment of $500 will not trigger a capital gain under CGT Event E4.

It might be noted that the result can be different under CGT event E4 if some other CGT preferences (such as pre 1999 indexation are distributed through a trust). This is because of the scope of the exclusions listed in s104-71.

D. EXAMPLE 3

Assume the facts in Example 1 with the variation that the trust made a capital loss of $200 on another asset.

Trust level

Trust income	$ 800
Net income	$ 800 s95(1) *ITAA*
Distribute	$ 800

Beneficiary level

Division 6E income s102UY(2)	$ 0
Division 6E net income s102UY(3)	$ 0
Division 6E present entitlement s102UY(4)	$ 0

Therefore no s97(1) assessment

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62 This is the view taken in ATO ID ATO 2003/28 "Income Tax: Capital Gains: Does CGT Event E4 in section 104-70 of the ITAA 1997 happen if the trustee of a discretionary trust makes a non-assessable payment to: (a) a mere object; or (b) a default beneficiary?"

63 (1994) 28 ATR 161.

ITAA 1997 s115-215(3) Div 102 applies as if beneficiary had capital gain equal to s115-225(1) amount

s115-225(1) amount will be:

capital gain at the trust level (allowing for capital loss offsets) x beneficiary's share of capital gain/capital gain

Here

800 x beneficiary's share of capital gain/capital gain

The beneficiary's share of capital gain determined under s115-227(a) [(b) is not applicable here]. This takes us to s115-228 to determine the amount of the capital gain to which the beneficiary is specifically entitled.

Under s115-228(1) this will be

Capital gain ($1000) x share of net financial benefit/net financial benefit

Here share of net financial benefit will be $800 and net financial benefit will be $800

Hence beneficiary's share of net capital gain will be $1000 x $800/$800 = $1000

Hence the s115-225 amount will be:

$800 x $1000/$1000 = $800

E. EXAMPLE 4

Assume the facts in Example 1 with the variation that the trust has $1000 of other income but has $800 of deductions.

Trust level

Trust income	$1200	
Net income s95(1)	$1200 *ITAA*	
Distribute		$1200

Beneficiary level

Division 6E income s102UY(2) capital gain)	$ 200 (ie disregard the $1000
Division 6E net income s102UY(3) capital gain)	$ 200 (ie disregard the $1000
Division 6E present entitlement s102UY(4) capital gain)	$ 200 (ie exclude the $1000
Therefore s97(1) assessment	$ 200

ITAA 1997 s115-215(3) Div 102 applies as if beneficiary had capital gain equal to s115-225(1) amount

s115-225(1) amount will be:

> capital gain at the trust level (allowing for capital loss offsets) x beneficiary's share of capital gain/capital gain
>
> Here 1000 x beneficiary's share of capital gain/capital gain

The beneficiary's share of capital gain is determined under s115-227(a) [(b) is not applicable here]. This takes us to s115-228 to determine the amount of the capital gain to which the beneficiary is specifically entitled.

Under s115-228(1) this will be

> Capital gain $1000 x share of net financial benefit/net financial benefit
>
> Here 'share of net financial benefit' will be $1000 and 'net financial benefit' will be $1000

Hence the beneficiary's share of net capital gain will be $1000 x $1000/$1000 = $1000

Hence the s115-225 amount will be:

> $1000 x $1000/$1000 = $1000

Note that the approach taken has the same effect as would arise from applying the deductions against the other income first.

If deductions were applied proportionately against all income there would be an element of double taxation ie $600 under s97(1) and $1000 as a capital gain. This result still occurs if the beneficiary's share of net financial benefit is regarded as being reduced to $600 by the application of a proportion of deductions against the capital gain. If that interpretation is applied then the s115-225 amount will still be $1000 as the denominator in the fraction, the net financial benefit, will also be $600. The double taxation result is anomalous and depends on the manner in which deductions at the trust level are regarded as being applied against different income categories. Note s115-215(5) states that s118-20 does not reduce the capital gain that s115-215(3) treats you as having for the purpose of Div 102.

F. EXAMPLE 4.1 – Application of s115-225(2) and (3) where deductions exceed other income

What if the trust has other income of $1000 but the deductions are $1200? Otherwise assume the facts in Example One and that the trust continues to have a capital gain of $1000 with a discount not being available.

Trust income	$ 800
Net income s95(1)	$ 800
Distribute	$ 800
Beneficiary level	
Division 6E income s102UY(2)	$ 0 (ie disregard the $1000 capital gain)
Division 6E net income s102UY(3)	$ 0 (ie disregard the $1000 capital gain)
Division 6E present entitlement s102UY(4)	$ 0 (ie exclude the $1000 capital gain)

Therefore s97(1) assessment	$ 0

[Note that the s102UY(2), (3) and (4) amounts cannot be negative amounts.

In this situation it is necessary to consider the operation of s115-225(2). Subsection 115-225(2) applies where the net income of the trust estate (disregarding franking credits) falls short of: (a) the net capital gain (if any) of the trust estate for the year; and (b) the total of all franked distributions included in the net income of the trust estate after reducing them by deductions that were directly relevant to them.

Here the net income of the trust estate is $800 (because other deductions were offset in calculating net income) but the net capital gain was $1000. Hence s115-225(2) will apply and the amount determined under s115-225(3) will be:

> capital gain at the trust level (allowing for discounts and capital loss offsets – not applicable here) x net income of the trust estate/net capital gain at trust level
>
> Here
>
> 1000 x 800/1000 = $800

Hence $800 is taken into account under Division 102.

If the method in s115-225(1) had applied it would have produced the anomalous result of $1000 being taken into account under Division 102 at the beneficiary level even though the beneficiary is only receiving $800. There would be an element of over taxation if the method in s115-225(1) had applied.

G. EXAMPLE 5 – Position where income and capital beneficiaries differ

Resident trust with 1 sui juris resident life tenant beneficiary entitled to 'trust income' and 1 remaninderman entitled to capital distribution on termination of life tenancy . Trust law determines trust income and ITAA 1936 s95 determines 'net income'. Trust makes a capital gain of $1000 and is allowed a 50% discount on the capital gain. Trust has other income of $1000. Capital gains are not considered to be trust income.

Trust income	$ 1000
Net income	$ 1500
Distribute	$1000 to life tenant
Life tenant	
Div 6E income	$1000 s102UY(2)
Div 6E net income	$1000 s102UY(3)
Div 6E present entitlement	100%
Life tenant taxed under s97(1)	$ 1000
Remainderman	
Div 6E present entitlement	$ 0
Therefore no Div 6 assessment on Remainderman	
Trustee	
Div 6E present entitlement	$ 0

ITAA 1997 s115-215(3) Div 102 applies as if beneficiary had capital gain equal to s115-225(1) amount.

The s115-225(1) amount will be:

> capital gain at the trust level (allowing for capital loss offsets) x beneficiary's share of capital gain/capital gain

This will be:

> 500 x beneficiary's share of capital gain/capital gain

The beneficiary's share of capital gain is determined under s115-227(a) or s115-227(b) if (a) is not applicable. We need to refer to s115-228 to determine the amount of the capital gain (if any) to which the beneficiary is specifically entitled.

Under s115-228(1) this will be:

> Capital gain ($1000) x share of net financial benefit/net financial benefit

Does the remainderman at this point has a share of the net financial benefit? It is not an amount that the remainderman has received. Is it an amount that the remainderman 'can be reasonably expected to receive'? The Explanatory Memorandum to Taxation Laws Amendment (2011 Measures No 5) Bill 2011 contains the following comment on this expression:

> "*A beneficiary can reasonably be expected to receive an amount if, for example, the beneficiary has a present entitlement to the amount; a vested and indefeasible interest in trust property representing the amount; or, the amount has been set aside exclusively for the beneficiary. In other words, even if the beneficiary is not "presently entitled" to the trust amount, it is reasonable to expect that the beneficiary will become entitled to it.*"

Here the beneficiary's interest would be vested in interest but not be indefeasible. Also, as the interest of the beneficiary is successive the beneficiary would not be presently entitled. While not free from doubt it is arguable that the remainderman does not yet have a share of the net financial benefit.

The trustee can elect under s115-230 as clearly no part of the capital gain has been paid (etc) to a beneficiary. If the choice is made the s115-230(4)(b) will mean that the trustee is specifically entitled to all of the capital gain. The choice will also mean that s115-215 and s115-220 do not apply. Rather s115-222 will apply and the trustee will be assessed and liable to pay tax under either s99 or s99A.

If s99 applies to the trustee then the amount on which the trustee is assessed is increased by the s115-225(1) amount (ie the discounted capital gain) ie $500. That is having had this amount excluded from s99 by s102UY it is now added back in. Note though that only the discounted capital gain is added back in. The remaining $500 will not be taxed to either the beneficiary or the trustee at this point. A subsequent distribution of this discount should receive the same treatment as discussed in Example 2 above in relation to s99B, CGT Event E5, CGT Event E7 and CGT Event E4.

If s99A applies to the trustee then the amount on which the trustee is assessed is increased under s115-222(4)(b) by twice the s115-225(1) amount. This has the effect of removing the discount and of taxing the trustee on the discount component at penal rates. It may be questioned whether this is a fair result in these circumstances.

If the trustee does not choose under s115-230 then we go to s115-227(b) and the trustee's share of the capital gain will be the non-discounted amount of the capital gain multiplied by the trustee's 'adjusted Division 6 percentage of the income of the trust estate'.

$1000 x trustee's adjusted Division 6 percentage of the income of the trust estate

Here the life tenant has a 100% entitlement to the income of the trust estate. It cannot be said that there is a percentage of the income of the trust estate to which no beneficiary is presently entitled. Therefore the trustee's share of the capital gain will be $0.

Can s115-227(b) mean that the life tenant has a capital gain taken into account for Div 102 purposes? The life tenant is not specifically entitled to the capital gain. Under s115-227(b) the life tenant's share of the capital gain will be the non-discounted amount of the capital gain multiplied by the life tenant's 'adjusted Division 6 percentage of the income of the trust estate'. Under s95 the life tenant's 'Division 6 percentage' is the share (expressed as a percentage) of the income of the trust estate to which the beneficiary is presently entitled. Here this is 100%. Under s95 the life tenant's 'Adjusted Division 6 percentage' is the Division 6 percentage calculated on the assumption that the amount of the capital gain to which the life tenant is specifically entitled were disregarded. As the life tenant is not specifically entitled to any capital gain the adjusted Division 6 percentage would still appear to be 100%. If this analysis is correct then, anomalously, the life tenant will have the following capital gain taken into account for Div 102 purposes:

$1000 x 100% = $1000.

This is despite the fact that the life tenant will never receive this capital gain which clearly would be an anomalous result.

Clearly in these circumstances the trustee should make the choice under s115-230.

H. EXAMPLE 5.1

Assume the facts in Example 5 with the variation that in year 2 the capital beneficiary has a capital loss of $200 on another asset at the beneficiary level. Assume that the beneficiary has no other capital gains.

Assuming that the trustee makes the choice under s115-230 the position in year 1 is unchanged.

If s99 applies the discounted capital gain is added back in and the trustee is assessed on it. Neither the trustee nor the remainderman is assessed on the discount component at this point.

In year 2 the operation of s99B, and CGT events E4, E5 and E7 as discussed at Example 2. In the case of a discretionary trust there should be no taxation of the distribution of either the taxed or the discount component at the time of distribution if the beneficiary did not (as would usually be the case) pay any consideration of the beneficiary's interest in the trust. The remainderman will not be required to offset the capital loss on the other asset against the distribution from the trustee.

If s99A applies then the amount on which the trustee is assessed is increased under s115-222(4)(b) by twice the s115-225(1) amount. This has the effect of removing the discount and of taxing the trustee on the discount component at penal rates.

In year 2 the operation of s99B, and CGT events E4, E5 and E7 as discussed at Example 2. In the case of a discretionary trust there should be no taxation of the distribution of either the taxed or the discount component at the time of distribution if the beneficiary did not (as would usually be the case) pay any consideration of the beneficiary's interest in the trust. The remainderman will not be required to offset the capital loss on the other asset against the distribution from the trustee.

I. EXAMPLE 5.2

Assume the facts in Example 5.1 with the variation that the capital beneficiary also has a capital gain of $500 on another asset on which neither discount nor indexation is available.

Assuming that the trustee makes the choice under s115-230 the position in year 1 is unchanged.

The position in year 2 is also unchanged from that discussed in Example 5.1. The remainderman will only be able to offset the capital loss against the gain from the other asset.

J. EXAMPLE 5.3

Trust where income beneficiary is entitled to current distributions of trust income and capital beneficiary is entitled to current distributions of capital gains as determined under trust law. Trust has $1000 of trust income and $1000 of capital gain for trust law purposes. For tax law purposes a 50% discount is available for the capital gain.

Trust income	$ 1000
Trust capital gain	$ 1000
Net income	$ 1500
Distribute	$1000 to income beneficiary
Distribute	$1000 to capital beneficiary
Income Beneficiary	
Div 6E income	$1000 s102UY(2)
Div 6E net income	$1000 s102UY(3)
Div 6E present entitlement	100%
Income beneficiary under s97(1)	$ 1000
Capital Beneficiary	
Div 6E present entitlement	$ 0

Therefore no Div 6 assessment on capital beneficiary

Under *ITAA* 1997 s115-215(3) Div 102 applies as if the capital beneficiary had a capital gain equal to s115-225(1) amount. This will be the amount of the capital gain remaining after applying steps 1 to 4 in s102-5(1) ie $500 x your share of the capital gain/ the amount of the capital gain. Your share of the capital gain is calculated under the combined operation of s115-227(a) and s115-228.

Hence the amount of the capital gain to which the beneficiary is specifically entitled under s115-228 is:

$1000 x $1000/$1000 = $1000

Hence the s115-225(1) amount is

$500 x $1000/$1000 = $500

As the 50% discount took place at the trust level s115-215(3)(b) means this amount is multiplied by two making the amount to which Div 102 applies $1000.

K. EXAMPLE 5.4

As per Example 5.3 but with the variation that the trust incurred deductions of $300 relating to the trust income.

Trust income	$ 700
Trust capital gain	$ 1000
Net income	$ 1200 (700 + 500)
Distribute	$ 700 to income beneficiary
Distribute	$1000 to capital beneficiary
Income Beneficiary	
Div 6E income	$ 700 s102UY(2)
Div 6E net income	$ 700 s102UY(3)
Div 6E present entitlement	100%
Income beneficiary under s97(1)	$ 700
Capital Beneficiary	
Div 6E present entitlement	$ 0

Therefore no Div 6 assessment on capital beneficiary

Under *ITAA* 1997 s115-215(3) Div 102 applies as if the capital beneficiary had a capital gain equal to s115-225(1) amount. This will be the amount of the capital gain remaining after applying steps 1 to 4 in s102-5(1) ie $500 x your share of the capital gain/ the amount of the capital gain. Your share of the capital gain is calculated under the combined operation of s115-227(a) and s115-228.

Hence the amount of the capital gain to which the beneficiary is specifically entitled under s115-228 is:

$1000 x $1000/$1000 = $1000

Hence the s115-225(1) amount is

$500 x $1000/$1000 = $500

As the 50% discount took place at the trust level s115-215(3)(b) means this amount is multiplied by two making the amount to which Div 102 applies $1000.

L. EXAMPLE 6 – The Effect Of The Market Value Substitution Rule

Trust with an income beneficiary and a capital beneficiary who are both entitled to current distributions. Trust has trust income of $1000 and a capital gain for trust law purposes of $1000. For tax purposes the market value substitution rule means that the capital gain is $1500. No discount is available on this capital gain for tax law purposes.

Treatment under current law

ITAA 1997 s115-228(3) will mean that the market value substitution rule is disregarded as in this circumstance it would have the effect of increasing the capital gain. This means that for Subdivision 115-C purposes the capital gain will be $1000. The addition $500 of capital gain produced by the market value substitution rule will be taken into account via the adjusted Division 6 mechanism.

Trust level

Trust income	$1000
Capital Gain (trust law)	$1000
Capital Gains (tax law)	$1500
Net income	$1500s95(1) ITAA
Distribute	$1000 to income beneficiary
Distribute	$1000 to capital beneficiary

Beneficiary level

Division 6E income s102UY(2)	$ 500
Division 6E net income s102UY(3)	$ 500
Division 6E present entitlement of income beneficiary	$ 500 s102UY(4) 100%
Division 6E present entitlement of capital beneficiary entitled to income of the trust estate.	s102UK(4) 0% as not presently

Therefore income beneficiary is taxed under s97(1) on $1500 being $1000 of income distributed and $500 of the excess of the capital gain calculated for tax purposes at the trust level over the capital gain calculated for tax purposes. This is despite the fact that the income beneficiary has no entitlement to any capital gain.

ITAA 1997 s115-215(3) Div 102 applies as if the capital beneficiary had capital gain equal to s115-225(1) amount. This will be the amount of the capital gain ($1000) x your share of the capital gain/the amount of the capital gain.

Here s115-227(a) applies to determine your share of the capital gain. This will be the share of the capital gain to which the entity is specifically entitled. That takes us to s115-228.

Under s115-228 the share of the capital gain to which the beneficiary is specifically entitled is:

Capital gain x share of net financial benefits/net financial benefits

'Net financial benefit' is defined in s115-228(1) as an amount equal to the financial benefit that is referable to the capital gain after the application of losses (but not discounts) by the trustee. A question arises as to whether the question of referability to the capital gain is determined from the perspective of the trust or from the perspective of the beneficiary. Arguably this should be viewed from the trust perspective although the legislation does not expressly state from which perspective this should be determined. Note that losses are taken into account but that discounts are not. Hence here net financial benefit will be $1000.

Under s115-228(1) 'share of net financial benefit' is the share of the financial benefit that the capital beneficiary has received or can reasonably be expected to receive and is referable to the capital gain (after allowance of losses but not discounts). Here the capital beneficiary has received $1000 and that is arguably the capital beneficiary's share of the net financial benefit.

$1000 x $1000/$1000 = $1000

Therefore the s115-225(1) amount is $1000 x $1000/$1000 = $1000

M. EXAMPLE 7 – Where Net Income Includes Amount Attributed Under The CFC Rules

Trust with a non-discountable capital gain of $1000 to which the capital beneficiary is entitled to have currently distributed and no trust income to which the income beneficiary is entitled to have currently distributed. The trust has an interest in a CFC and has $1000 of foreign source passive income attributed to it under the CFC rules. If the deduction at the trust level is limited to the amount actually distributed the result will be:

Treatment under current law

Trust's position

Trust income $0

Trust capital gain $1000

Tax capital gain $1000

Net income $2000 (being $1000 capital gain and $1000 s456 attributed income)

Division 6E income s102UY(2) $ 0

Division 6E net income s102UY(3) $1000

Division 6E present entitlement of income beneficiary s102UY(4) 0%

Presumably in this situation the trustee will be assessed and liable to pay tax on the $1000 of CFC income under either s99 or s99A on the basis that there is no beneficiary presently entitled to a share of the income of the trust estate.

Division 6E present entitlement of capital beneficiary s102UK(4) 0% as not presently entitled to income of the trust estate.

ITAA 1997 s115-215(3) will mean that Division 102 will apply to the capital beneficiary for each capital gain of the trust estate as if the beneficiary had, in this instance, a capital gain equal to the s115-225(1) amount. As per the analysis above in this situation the capital beneficiary's s115-225(1) amount will be $1000 x $1000/$1000 = $1000.

A subsequent distribution by the CFC to the trust will be non-assessable non-exempt income to the income beneficiary under *ITAA* 1936 s23AI(1)(d). If foreign withholding tax is levied on the distribution by CFC then the combined operation of *ITAA* 1997 s770-10(2), s770-80 and s770-130 will mean that the trust receives a foreign income tax offset for the foreign withholding tax. There would be a timing disparity here as the attributed income would have been assessable to the trust in year 1 while the foreign income tax offset would have only been available in the year of distribution. This, however, is consistent with the treatment of other Australian entities under the combined operation of the CFC regime and the foreign income tax offset regime. Nonetheless the result is inappropriate as the trust would be able to apply the foreign income tax offset against items such as capital gains to which the income beneficiary is not entitled. Assuming that the trustee distributes the CFC attributed income to the income beneficiary the distribution should be protected from the operation of *ITAA* 1936 s99B by s99B(2)(c)(ii). There should also not be an operation of CGT events E4, E5 or E7 for the reasons discussed above.

5. A back to the future proposal: 1915 revisited

The approach to taxing trusts taken in the *Income Tax Assessment Act* 1915 was outlined at 2 in this paper. In brief, the tax was levied at the trust level with the trustee being allowed a deduction proportionate to the income distributed to beneficiaries. Beneficiaries were taxed on beneficial interests in income derived with no reference being made to the concept of 'present entitlement'. At 3 in Part 1 it was also argued that the abandonment of this approach in 1918 and the adoption of 'present entitlement' as the touchstone for assessment of beneficiaries was to combat a perceived inequity arising due to the locking in of losses at the partnership level. It was argued that this led to the adoption of the 'conduit' rather than the entity approach to taxing partnership income and that the adoption of a 'conduit' approach to taxation of trust income was a product of giving conceptually equivalent tax treatment to partnerships and trusts. It was noted that, notwithstanding the changes in 1918, trusts losses continued and continue to be 'locked in' at the trust level. Hence the 'inequity' perceived to exist in the pre 1918 tax treatment of partnerships and trusts was not removed in the case of trusts by the 1918 changes.

By making taxation at the beneficiary level relate to the share of trust income to which the beneficiary was presently entitled the 1918 changes and subsequent legislative developments would eventually produce complexity, uncertainty and inequity into the tax treatment of trust income. The approach was appropriate enough in a when trust income and ordinary income were largely the same, where trusts were largely not for business or investment purposes and where distributions of current year capital gains were required to accretions to corpus.

Developments in tax law and in trust law since 1918 have meant that none of these conditions can be said to apply to all trusts. Net income for tax purposes can differ from trust income, current year capital gains can be (and are) distributed to beneficiaries, and trusts are commonly used for business and investment purposes. These developments have made linking taxation of beneficiaries with their present entitlement to a proportion of trust income problematic and inequitable. Part 4.2 endeavoured to show that the 2011 amendments to Sub Division 115-C of *ITAA* 1997 and to *ITAA* 1936 Division 6 of Part III not only increased the textual and effective complexity of the taxation of capital gains derived through trusts but also produced inequitable and anomalous results in particular cases.

The proposal in this paper involves returning to an approach broadly equivalent to that adopted in 1915. The paper proposes taxing the trustee on accumulated income, allowing the trustee a deduction for distributions to beneficiaries, taxing beneficiaries in taxable income actually received and allowing beneficiaries a credit for tax paid by the trustee on distributions of taxed accumulated income. The proposal is based on the assumption that a trustee knows, or at least should know, what the tax character of amounts distributed to beneficiaries is. The proposal discusses design options to adjust the basic model proposed to deal with problematic circumstances highlighted in Part 4.2. The basic design and the options for modification are also cognisant of difficulties associated with the similar approach adopted in Sub-chapter J of the United States *Inland Revenue Code of 1986.*

Subchapter J of the United States *Internal Revenue Code 1986* ('Subchapter J') contains an approach for taxing trusts and beneficiaries that shares many of the key characteristics of the reform proposed in this paper with trusts being taxed on retained income and being allowed a deduction for certain distributed income.

Evans provides a detailed critique of Subchapter J.[64] The design challenges associated with Subchapter J provide valuable 'lessons learnt' in designing a similar regime for application in the Australian context. In particular, there are three key design issues that are present in Subchapter J which would be pre-empted and avoided by the reform proposal suggested in this paper. Each of these are dealt with in turn below.

First, Subchapter J allows a deduction for trust income that the trust is required to distribute and limit the deduction by a "distributable net income" ('DNI') concept. The trust income concept used is very similar to the Australian 'trust income' concept and the DNI concept is very similar to the Australian 'net income of the trust estate' concept. Evans notes that:[65]

> "*Trusts that act as mere conduits are treated as simple trusts and trusts that allow accumulation of income and distributions of those amounts in later years are treated as complex trusts. For a simple trust, the amount of the distribution deduction and income inclusion is, prima facie, limited to the amount of income that is "required to be distributed currently" … The pure distribution deduction and income inclusion figure (that is, before either are affected by DNI) in both the simple and complex regimes, fix on the amount of income of the current tax year that is "required to be distributed currently".*"

While it is arguable that the deduction and inclusion being triggered by the amount required to be distributed are very similar to 'present entitlement', this conclusion is an avoidable one. Specifically, if the Australian regime continues to allow tax preferences to flow through trusts and for income to retain its character as it flows through a trust, then only looking at actual distributions will require some characterisation or tracing rules which will have complexity but arguably less so than our current rules. Presumably the trustee or the trustee's advisors know what types of income they have actually distributed to beneficiaries. Here, assuming that preferences are to flow through, then the upper limit of the deduction would be the amount of 'net income' distributed. While it would certainly be simpler for preferences to not be allowed to pass through a trust, in effect becoming equivalent to the treatment of corporate distributions, allowing tax preferences to flow through trusts is probably the only politically feasible possibility. Part 2 of this paper sets out worked examples exploring the more challenging situations where the 'net income' is greater than the amount actually distributed.

Second, some of the existing features contained in Subchapter J are in place to combat accumulation trusts.[66] This would not be required in an Australian distribution-based model as is proposed in this paper because the mechanism under section 99A of the *ITAA* 1936 would continue to operate except for those situations where capital and income beneficiaries differ and a capital gain is retained for future distribution to a capital beneficiary. The retained income would be taxed to the trust and on distribution the trust would either obtain a deduction with a loss carry backward and a refund of the earlier tax or, preferably, the beneficiary could obtain a credit for the tax paid by the trust (similar to what currently happens in companies or what did happen with companies in the *ITAA* 1915). In summary, it

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[64] See further, Evans A, 'The "economic benefits model" for trusts – fool's gold?' (2014) 43 Australian Tax Review 162.
[65] Evans A, 'The "economic benefits model" for trusts – fool's gold?' (2014) 43 Australian Tax Review 162, 176.
[66] Evans A, 'The "economic benefits model" for trusts – fool's gold?' (2014) 43 Australian Tax Review 162, 179.

would be possible to develop rules having a similar function to the US 'throwback rules' that are simpler and a more appropriate in the Australian legislative context.

Third, Evans notes the complexity around the distinction between simple, complex and grantor trusts (grantor trusts are likely reversionary trusts).[67] However, the simple-complex distinction hinges on whether the trust can accumulate income, which in turn leads into ordering and characterisation rules which are driven by a desire to allow preferences and character to flow through trusts. However, as mentioned above, it should be possible for a trustee to know what they are distributing and to advise the beneficiaries appropriately.

APPLYING THE PROPOSED APPROACH TO THE EXAMPLES IN PART 4.2 ABOVE

A. EXAMPLE 1 – Under the proposed approach

Trust level

Trust income	$1000
Tax income	$1000
Distribute	$1000
Deduction	$1000
Tax at trust level	$ 0

Beneficiary level

Distribution received	$1000 included in assessable income

B. EXAMPLE 2 – Under the proposed approach

Trust level

Trust income	$ 1000
Tax income	$ 500
Distribute	$ 1000
Deduction	$ 500
Tax at trustee level	$ 0

Beneficiary level

Distribution received	$1000
Exempt component	$ 500
Taxable component	$ 500 included in assessable income

If beneficiary has no capital losses beneficiary is taxed on taxable component

[67] Evans A, 'The "economic benefits model" for trusts – fool's gold?' (2014) 43 Australian Tax Review 162, 175.

If beneficiary is a company then taxed on both taxable and exempt component

If beneficiary has capital losses then add both the taxable and exempt components, then offset loss, then apply discount

Where sum of exempt and taxable component equals twice the taxable component then beneficiary knows that 50% discount was applied at trust level.

Where sum of exempt and taxable component equals four times the taxable component then beneficiary knows that 50% discount and small business 50% discount were both applied at trust level

C. EXAMPLE 2.1 – Under the proposed approach

Year 1

Trust level

Profit on realisation	$ 1000
Trust income	$ 500
Tax Income	$ 500
Distribute	$ 500
Deduction	$ 500
Tax at trustee level	$ 0

Accumulated income becomes corpus

Beneficiary level

Distribution received	$500 included in assessable income

Year 2 – distribution of corpus can now be made to beneficiary

Here there the operation (or non-operation of s99B and CGT events E4, E5 and E7 will be as discussed in Example 2.1

D. EXAMPLE 3 – Under the proposed approach

Trust level

Trust income	$ 800
Tax income	$ 800 s95(1) ITAA
Distribute	$ 800
Deduction	$ 800
Tax at trustee level	$ 0

Beneficiary level

Distribution received	$800 included in assessable income

E. EXAMPLE 4 – Under the proposed approach

Trust level

Trust income	$1200
Net income s95(1)	$1200 ITAA
Distribute	$1200
Deduction	$1200
Tax at trustee level	$ 0

Beneficiary level

Irrespective of how the trustee applies deductions the result will be as follows:

Distribution received	$1200 included in assessable income.

F. EXAMPLE 4.1 – Under the proposed approach

Trust level

Trust income	$ 800
Tax income s95(1)	$ 800
Distribute	$ 800
Deduction	$ 800
Tax at trust level	$ 0

Beneficiary level

Distribution received	$ 800 included in assessable income

G. EXAMPLE 5 – Under the proposed approach

Trust's position Y1

Tax income	$1500
Distribute	$1000 to income beneficiary
Deduction	$1000
Income liable to tax	$ 500
Tax at say 30%	$ 150

Income beneficiary Y1

Distribution received	$1000 added to assessable income

Year 2 – assume income beneficiary dies and capital beneficiary is entitled to distribution of retained gain – assume that there are no further capital gains and no further trust income in year 2

Trust position

Distribution to capital beneficiary	$ 850
Credit allocated for tax paid in Y1	$ 150

Capital beneficiary

Distribution received	$ 850
Credit received	$ 150
Exempt portion	$ 500
Taxable portion	$ 350
Gross up for credit	$ 150
Grossed up taxable portion	$ 500 included in assessable income
Tax payable (say @ 40%)	$ 200
Tax offset for credit	$ 150
Net tax payable	$ 50
After tax distribution	$ 800

H. EXAMPLE 5.1 – Under the proposed approach

The position under current law was discussed at Example 5.1. Assuming that the trustee makes the choice under s115-230 the life tenant is not assessed on the capital gain. If the trustee is assessed under s99 then the assessment will be only on the discounted capital gain. If the trustee is assessed under s99A then the assessment will be on the whole of the capital gain without allowing for the discount and will be at penal rates. When a distribution is made to the remainderman in year 2 no part of the distribution should be assessable to the remainderman but the remainderman will not be required to offset the capital loss against the distribution from the trustee.

Under the proposed approach unless the ordering rules for the application of capital losses were changed the loss would not be absorbed against the capital gain with the result that in the one year there would be a grossed up capital gain of $1000 that was taxable and a net capital loss of $200 that was carried forward. This would be an unusual result but would be functionally equivalent to the result under the current rules as discussed in Example 5.1.

Under the proposed approach it would be possible to change the ordering rule for the application of capital losses. If this were done generally it would have the effect of increasing the value of discounts which are already too generous. An across the board change in the ordering rule might be more justified if discounts were reduced from 50% to say 40% or less. This approach would have the virtue of simplicity.

An alternative option would be to change the ordering rule for the application of losses where a capital gain passes through a trust to enable the capital gain to be offset against the discounted gain after the discount had been applied. Again this would be a relatively simple solution but would be more targeted. As such it would not amount to giving equivalent tax treatment to capital gains passing through different types of intermediate entities.

In the trust context the effect of a change in the ordering rule for the application of capital losses would be as follows:

Yr 2

Capital beneficiary

Distribution received	$ 850
Credit received	$ 150
Exempt portion	$ 500
Taxable portion	$ 350
Gross up for credit	$ 150
Grossed up taxable portion	$ 500 included in assessable income
Apply capital loss	$ 200
Net grossed up taxable portion	$ 300
Tax at say 40%	$ 120
Tax offset for credit	$ 150
Net tax	$ (30) refund
After tax distribution	$ 880

Note that this approach produces a conceptually correct (albeit costly to the revenue) result with the net capital gain at the beneficiary level being subject to tax of $120 which represents tax at the beneficiary's marginal rate. It would not, however, produce an equivalent result to the position where both the capital gain and the capital loss had wholly been derived at the beneficiary level. There the ordering rule requiring the application of capital losses prior to the application of discounts would have reduced the value of the capital loss with the result that the net capital gain would have been subject to tax of $160.

A more complex option would be to adopt a more targeted version of the gross up approach currently used where capital gains are distributed to beneficiaries who are specifically entitled to them. Where the capital gain has benefitted from discounts (this could also be applied where small business discounts have applied) and the beneficiary has capital losses from other assets then the beneficiary would be directed to add the exempt capital gain portion of the trust distribution to the taxed portion before applying the capital losses and would then apply relevant discount. An advantage with this approach over the current law is that it would only apply where the beneficiary has capital losses from other assets. By affecting fewer beneficiaries it would reduce the effective complexity of the system. It would also mean that beneficiaries receiving distributions of capital gains that had been taxed to the trustee would be in an equivalent position to beneficiaries receiving capital gains to which they were specifically entitled in the year in which the capital gain was derived by the trust. The way this would work would be as follows:

Yr2

Capital beneficiary

Distribution received	$ 850
Credit received	$ 150
Exempt portion	$ 500
Taxable portion	$ 350
Gross up for credit	$ 150
Grossed up taxable portion	$ 500 included in assessable income
Add exempt portion	$ 500
Offset capital loss	$ 200
Capital gain prior to discount	$ 800
Discount	$ 400
Taxable	$ 400
Tax at say 40%	$ 160
Tax offset for credit	$ 150
Net tax	$ 10
After tax distribution	$ 840.

The result here is equivalent to the one that would be achieved if the beneficiary had derived the capital gain and had incurred the capital loss entirely at the beneficiary level. The price of this would be greater complexity than would otherwise arise under the proposed solution.

I. *EXAMPLE 5.2 – Under the proposed approach*

If there were no change to the present ordering rules on the application of capital loses then the capital loss of $200 would only be able to be offset against the other capital gain of $500. The effect at the beneficiary level would be as follows:

Capital beneficiary

Distribution received	$ 850
Credit received	$ 150
Exempt portion	$ 500
Taxable portion	$ 350
Gross up for credit	$ 150
Grossed up taxable portion	$ 500 included in assessable income
Capital gain on other asset	$ 500
Capital loss offset	$ 200
Net capital gain	$ 800 (ie $1000 + $500 - $200)

This produces the same result as a well advised taxpayer deriving a discountable capital gain, a non-discountable capital gain and a capital loss in the one year would achieve under the current ordering rules for the application of capital losses. That is a well advised taxpayer should apply capital losses against non-discountable gains first as the subsequent application of the discount has the effect of reducing the value of the capital loss if the capital loss is applied against discountable gains first. It is also the same result as is produced under current law assuming that the trustee makes the choice under s115-230.

If either of the alternative approaches discussed in Scenario 1.1 were adopted a well advised beneficiary would presumably choose to offset the capital loss against the non-discountable gain first thus producing the same result as shown above. The beneficiary would have the opportunity offset against the discountable first which would produce a larger taxable net capital gain. It might be questioned whether it is good policy to introduce rules that function to enable poorer choices to be made by taxpayers. Such rules favour the well advised over the ill advised.

J. EXAMPLE 5.3 – Under the proposed approach

Trust's position

Capital gain (trust law)	$1000
Capital gain (tax law)	$ 500
Trust income	$1000
Tax income	$1500
Distribute	$1000 to income beneficiary
Distribute	$1000 to capital beneficiary
Deduction amount of tax income at trust level)	$1500 (upper limit of deduction is
Trust Income taxable	$0

Income beneficiary

Trust distribution	$1000 added to assessable income

Capital beneficiary

Trust distribution	$1000
Exempt portion	$ 500
Taxable portion	$ 500 added to assessable income

K. EXAMPLE 5.4 – Under the proposed approach

Here the preferred approach would be to require allocation of deductions against the income to which they are most relevant. In this instance this would be the trust income of $1000. The issue is less difficult in the context of capital gains flowing through a trust than it is in the context of franking credits flowing through a trust. This is because, in the capital gains context, the CGT rules will require certain expenses to the capitalized and included in cost base of trust assets at the trust level in calculating capital gains and losses on those assets. That characterisation is generally exclusive due to the operation of *ITAA* 1997 s110-55(4), 110-55(5) and s110-55(9) although there may be circumstances where, due to the operation of the CGT market value substitution rule, a revenue loss deduction and part of a capital loss are obtained from the one transaction.[68] Although discussion of issues associated with franking credits flowing through a trust are beyond the scope of this paper it is submitted that there an allocation of deductions based on relevance is the preferred approach. The result under the preferred approach would be as follows:

Trust's position

Capital gain (trust law)	$1000
Capital gain (tax law)	$ 500
Trust income	$ 700 ($1000 less $300 of deductions)
Tax income	$1200
Distribute	$ 700 to income beneficiary
Distribute	$1000 to capital beneficiary
Deduction of tax income at trust level)	$1200 (upper limit of deduction is amount
Trust Income taxable	$0

Income beneficiary

Trust distribution	$700 added to assessable income

Capital beneficiary

Trust distribution	$1000
Exempt portion	$ 500
Taxable portion	$ 500 added to assessable income

If the deductions were allocated proportionately against trust income and the capital gain the result under the proposed approach would be as follows:

Capital gain (trust law)	$ 850 ($1000 less $150 of deductions)
Capital gain (tax law)	$ 500
Trust income	$ 850 ($1000 less $150 of deductions)
Tax income	$1200
Distribute	$ 850 to income beneficiary

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68 See the discussion in Taylor, Walpole, Burton, Ciro and Murray, *Understanding Taxation Law 2018*, Lexis Nexis, Sydney, 2018 at 6.122.

Distribute	$850 to capital beneficiary
Deduction	$1200 (upper limit of deduction is amount
of tax income at trust level)	
Trust Income taxable	$0
Tax at trust level	$0

Income beneficiary

Trust distribution	$850 added to assessable income

Capital beneficiary (assuming that deductions applied proportionately to the taxable and discounted components)

Trust distribution	$850
Exempt portion	$425
Taxable portion	$ 425 added to assessable income

In this situation a rule of relevance might need to be included for the purposes of determining the order of allocation of deductions.

L. EXAMPLE 6 – Under the proposed approach

One approach would be to limit the trust's deduction for the distribution to the actual amount of the distribution and to allow tax paid at the trust level to the allocated as a credit to the capital beneficiary.

Trust's position

Trust income	$1000
Trust capital gain	$1000
Tax capital gain	$1500
Tax income	$2500
Distribution	$2000 (as only $2000 of real income and
gain is available)	
Deduction	$2000
Taxable income	$ 500
Tax at say 30%	$ 150 generates a credit

Income beneficiary	$1000 included in assessable income
Capital beneficiary	$1000 included in assessable income
Credit for trust tax paid	$ 150 included in assessable income
Grossed up distribution	$1150

Tax at say 40%	$ 460
Credit for trust tax paid	$ 150
Net tax	$ 310
After tax distribution	$ 690

The result is equivalent to the 'super-integration' result referred to in the corporate-shareholder taxation literature. If overall taxation of the distribution to the capital beneficiary represented tax at the beneficiary's average rate then total tax of $600 on $1500 should have been payable.

A more appropriate result in this situation would be produced by allowing the trust a deduction up to the amount of taxable income of the trust rather than limiting the deduction to the amount actually distributed. This would need to be accompanied by an integrity rule to the effect that amounts deducted at the trust level in excess of amounts actually distributed would be included in the assessable income of the beneficiary to whose interest in the trust the market value substation rule has applied to. The operation of this approach would be as follows:

Trust's position

Trust income	$1000
Trust capital gain	$1000
Tax capital gain	$1500
Tax income	$2500
Distribution	$2000 (as only $2000 of real income and gain is available)
Deduction	$2500
Taxable income	$ 0

Income beneficiary	$1000 included in assessable income
Capital beneficiary	$1000 distribution included in assessable income
Excess deduction by trust	$ 500 included in assessable income
Taxable	$1500
Tax at say 40%	$ 600
After tax distribution	$ 400

M. EXAMPLE 7 – Under the proposed approach

Trust's position

Trust income	$0

Trust capital gain	$1000
Tax capital gain	$1000
Tax income	$2000 (being $1000 capital gain and $1000 s456 attributed income)
Distribution	$1000
Deduction	$1000
Tax at trust level	$ 300 (assuming a 30% rate)

Capital beneficiary

Distribution	$1000 included in assessable income

Income beneficiary

No inclusion this year but inclusion plus credit for tax paid at trust level when subsequent actual distribution made. This would raise the question of whether detailed tracking would be required at the trust level. For example, if in year 2 the trust had other trust income could the credit from year 1 be attached to a distribution of that income. We currently allow this to happen for companies. An adaptation of s23AI and of the foreign income tax offset rules would also be required. It would be necessary for the subsequent distribution by the CFC to be NANE income to the trust and for a payment of foreign withholding tax to generate a foreign income tax offset for the trust. Again there would be a timing disparity with the income being included in the tax income of the trust in the year of attribution but the foreign income tax offset for the withholding tax only being available in the year of distribution. This would be problematic as the tax income of the trust in the later year might include capital gains to which the income beneficiary would not be entitled and against which the foreign income tax offset would be applied. A mechanism, equivalent to s23AI(1)(c) would need to be developed to allow the foreign income tax offset to pass through the trust to the income beneficiary and to prevent it from being applied against trust income of the year the distribution is received from the CFC.

Alternatively if the deduction were not limited to the amount actually distributed but that the amount deducted were included in the assessable income of the beneficiary to whom it properly relates the result would be as follows:

Trust's position

Trust income	$0
Trust capital gain	$1000
Tax capital gain	$1000
Tax income	$2000 (being $1000 capital gain and $1000 s456 attributed income)
Distribution	$1000
Deduction	$2000

Tax at trust level	$ 0
Capital beneficiary	
Distribution	$1000 included in assessable income
Income beneficiary	
Distribution	$0
Excess deduction by trust	$1000 included in assessable income

A subsequent distribution by the CFC could be treated as non-assessable non-exempt income to the trust with a redistribution of it not being deductible to the trust and being non-assessable non-exempt income to the income beneficiary to whom it is distributed. It would be necessary to include provisions ensuring that any foreign income tax offset for any foreign withholding tax is only available to the income beneficiary and not to the trust.

6. Conclusion

Applying rules for taxing capital gains flowing through a trust to beneficiaries inevitably will invovolve significant complexity. The general law relating to trusts is complex, flexible and at times uncertain. Australia's capital gains rules contain many tax preferences and their own complex rules relevant to determining whether a capital gain is taxable and, if so, to what extent. The interaction of those sets of legal principles is bound to be complex particularly if the resultant treatment is to respect the principle that income flowing through a trust should retain its character. This paper has sought to minimise that complexity by making the point of taxation focus more on actual distributions with the tax attributes of those distributions being identified and notified by the trustee making them. While there may be situations where further modification and refinement of the approach outlined in this paper will be found to be necessary it is submitted that the approach merits consideration as a more simple solution to the problems that the 2011 amendments to *ITAA* 1997 Subdivision 115-C were intended to deal with.

Annexure A – Past reviews relating to both CGT and the taxation of trusts

The below summary highlights the challenges of maintaining coherence given the complexity of the subject matter by providing an overview of various major and minor reviews dealing with both the CGT regime and the taxation of trusts.

Date	Review name	Recommendations or outcomes
July 1998	Tax Law Improvement Project rewrite of the CGT provisions	This project aimed at simplifying the complexity of the tax law, and making it accessible to a wider spectrum of people. Division 104 made clear the CGT Events, many of which were just re-statements of the administrative practice of the Australian Taxation Office. Nonetheless, the new provisions explicitly confirmed the practice in legislative form by listing specific CGT events.
September 1999	Review of Business Taxation ('Ralph Review')	The Ralph Review recommended, inter alia, the adoption of a unified entity regime. This would include taxing most trusts like companies.[69] As noted by Vann, investment neutrality was the basis of this recommendation for the adoption of a unified entity regime, which was comprehensively rejected by the Government.[70] Ultimately, as observed by Kenny, the Ralph Review "*actually shifted the Australian capital gains tax regime further away from the comprehensive income ideal, with its capital gains tax discounts and other exemptions*".[71]
April 2001	The Treasury's Overview entitled 'Entity Taxation: Taxing Trusts Like Companies'	Released with the intention of removing the need for a CIV regime, the proposed legislation for taxing trusts like companies was thought to achieve the objective of greater consistency in the taxation of entities while minimising compliance and restructuring costs. Under this approach, non-fixed trusts would be taxed like companies. This marked a departure from the ideals espoused by the Ralph Review.[72]
November 2002	Board of Taxation's Review of the Taxation of Discretionary Trusts	This review focussed on 'tax abuse in the trust area'. The Board was able to conclude that "*no significant change was required to the status quo*".[73] This review provides a comprehensive overview of the developments since the August 1998 Government proposal to tax all trusts like companies, which was eventually abandoned (after being narrowed down to cover only discretionary trusts); "*On 27 February 2001, the Treasurer announced that, in light of these technical problems and advice from the Board of Taxation, the*

[69] Specific categories were carved out in Recommendations 16.10-11; namely, 'Trusts excluded from entity taxation' and 'Trusts for absolutely entitled beneficiaries disregarded for tax purposes', respectively. See further, "*The Ralph Review's proposed "tax value method" structural framework for business tax reform along with specific proposals for entity taxation were jettisoned not long after the Review's final report was issued. However, to the extent the Ralph Review was established by the Government of the day to back three specific changes – lower taxes on capital gains, a lower headline tax rate for companies, and scrip for scrip roll-overs – the sponsor of the Review achieved its goals. The intermediary drafters of the Review were less successful as the Government declined to adopt the range of safeguards and limitations that the designers saw as integral parts of the concessions*": http://www.austlii.edu.au/au/journals/UNSWLRS/2009/24.html.

[70] Vann R, 'Australia's policy on entity taxation' (2001) 4(3) *Tax Specialist* 120, 124; see further, Freudenberg, B, 'Entity Taxation: The Inconsistency Between Stated Policy And Actual Application' (2005) 1(2) *Journal of the Australasian Tax Teachers Association* 458.

[71] Paul Kenny, 'A review of the 1999 Australian Capital Gains Tax Reforms' (Paper presented at the Tax Research Network Conference, 16 July 2003), 1.

[72] "*However, over time it appeared that the government's belief in a more consistent taxation treatment of business entities wavered. This is because over a year later, on 11 October 2000, when the government released its own Exposure Draft Bill for entity taxation, the measures only applied to non-fixed trusts. The term 'unifying' was a stark omission from the title of the government's Exposure Draft Bill. Some identified the omission of 'unified' in the Exposure Draft Bill's title as an indication of a departure from the ideals espoused by the Ralph Committee. Instead of providing uniform rules for a number of entities, entity taxation now appeared to be specific anti-avoidance provisions addressing concerns about the taxation of non-fixed trusts only.*": Freudenberg, B, 'Entity Taxation: The Inconsistency Between Stated Policy And Actual Application' (2005) 1(2) *Journal of the Australasian Tax Teachers Association* 458, 466.

[73] http://taxboard.gov.au/consultation/taxation-of-discretionary-trusts/ .

		Government would not proceed with draft legislation providing for the taxation of non-fixed trusts like companies".[74]
November 2008	The Treasury's Discussion Paper entitled 'Abolish the Capital Gains Tax Trust Cloning Exemption'	As noted by practitioners Ellis and Taylor-Sands, trust cloning was a widely adopted tax planning strategy which enabled the transfer of assets without triggering a CGT event.[75] Most of the submissions on the policy design of the measure to abolish the CGT trust cloning exception opposed abolishing the exception on the basis that there were non-tax reasons for using trust cloning. The Treasury response was "*Although there may be non-tax reasons for the transfer, this does not mean it should not give rise to a CGT taxing point*"[76] and the amendments were passed in 2010.[77] However, similarly to 'Trust Cloning', 'Trust Splitting' is still used today and achieves a similar outcome with respect to CGT; namely, while the cloning process relied on the former exemption for a CGT Event E2, splitting looks to that exemption and provisions applicable to CGT Event E1.[78] It is noteworthy that the ATO has recently release draft determination TD 2018/D3 (in July 2018), which expresses the view that the splitting of a trust may amount to a resettlement of some of the trust property thereby triggering CGT Event E1.[79]
August 2009	Board of Taxation's Review of the Tax Arrangements Applying to Managed Investment Trusts	The Board made 48 recommendations seeking to improve certainty and reduce compliance costs for the managed funds industry and assist the industry's international competitiveness. As noted by the Board, "*There are several CGT provisions which apply specifically to trusts. The CGT treatment of a trust's assets and of beneficiaries' interests and entitlements can depend on a number of factors including the nature of the trust. For example, under the CGT provisions, there is a distinction made between deceased estates, unit trusts and other types of trusts. For CGT purposes, a different treatment applies where the beneficiary is taken to be absolutely entitled to the trust property. Acts of the trustee in relation to the assets are ignored and the beneficiary is taken to have done the acts for CGT purposes. In the context of MITs and other unit trusts, CGT applies separately to the disposal of trust assets by the trustee and the disposal of a beneficiary's unit in the trust.*"[80]
May 2010	Australia's Future Tax System Review ('Henry Review')	The Henry Review recommended that the current trust rules should be updated and rewritten to reduce complexity and uncertainty around their application (Recommendation 36).[81]

[74] https://cdn.tspace.gov.au/uploads/sites/70/2015/07/discretionary_trusts_final_report1.pdf, 3 and 19.

[75] "*Trust cloning became a popular tax planning strategy because it enabled assets pregnant with capital gains to be transferred from one trust to a new trust without triggering a CGT event. Circumstances in which trust cloning could be used included: when a trustee wished to rearrange the holding of business assets held in the one trust to more properly align different business assets with different business activities; or, when the trustee of a trust holding business and non-business assets wanted to protect the non-business assets from future risk by transferring them into a separate trust.*": Paul Ellis and Michael Taylor-Sands, 'Taxation alert: Trust cloning CGT exemption abolished' [February 2009]; available at: https://www.cleardocs.com/clearlaw/tax/trust-cloning-cgt-exemption-abolished.html.

[76] http://archive.treasury.gov.au/documents/1435/PDF/Consultation_Summary.pdf.

[77] See further: *Tax Laws Amendment (2009 Measures No. 6) Bill 2010* (Cth), which received Royal Assent on 24 March 2010.

[78] See, for example, Tucker J, 'Tax & other implications of trust splitting' 40(5) *The Bulletin (Law Society of South Australia)* [June 2018] 35.

[79] Gordon Cooper, Chris Evans, Ann Kayis-Kumar and Tim Russell, *Australian CGT Handbook 2018-19* (Thomson Reuters, 10th edition, 2019), Chapter 19.

[80] Review of the Tax Arrangements Applying to Managed Investment Trusts, Discussion Paper, Board of Taxation (October 2008), 16.

[81] "*The general rules governing the taxation of trusts rely on a mix of trust law concepts (which mostly derive from case law) and tax law concepts (which derive from case law and statute). Differing views on key concepts, such as 'present entitlement', 'income of the trust estate' and 'share', create uncertain tax outcomes for taxpayers, increasing compliance and administration costs. For example, there are differing views as to whether the income of the trust estate refers to net accounting profit, distributable or gross ordinary income, or whether it can vary according to the terms of the trust deed. In addition, the interaction between the income of the trust estate (which relates to present entitlement) and the net income of the trust (the basis for a beneficiary's tax liability) can be problematic; for example, when it comes to the treatment of capital gains derived through a trust.*"

		Also, the Henry Review suggested that if dividend imputation were to be abolished that a flow-through entity regime for closely held companies and fixed trusts be adopted (Recommendation 38).[82] While the Henry Review produced 138 recommendations for comprehensive tax reform very few of these recommendations have been adopted.
March 2011	The Treasury's Discussion Paper entitled 'Improving the taxation of trust income'	The Treasury acknowledged that the High Court decision in *Bamford v FCT* raised doubts, at least insofar as the ATO is concerned, as to whether "streaming" is possible. It stated that the Government intended to amend the law so that "streaming" would be possible for franked dividends and capital gains. In relation to the CGT regime, this paper noted that: "*The capital gains provisions contained in Subdivision 115-C of the ITAA 1997 were enacted to provide, among other matters, for appropriate amounts of the trust's taxable income that include a net capital gain to be treated as capital gains of presently entitled beneficiaries. This treatment allows beneficiaries to apply any capital losses they have against those extra capital gains and apply appropriate CGT concessions to any gain remaining.*"[83] As a result, the *Tax Laws Amendment (2011 Measures No. 5) Bill 2011 (Cth)* introduced amendments to broadly ensure that a beneficiary that is 'specifically entitled' to an amount representing a capital gain of a trust will be assessed on that gain.
November 2011	The Treasury's Consultation Paper entitled 'Modernising the taxation of trust income'	This paper outlines a number of options for reform, ranging from minor changes to the current operation of Division 6 to the introduction of a new model for the taxation of trust income.[84] Following on from the options proposed in the above Discussion Paper on Improving the taxation of trust income,[85] defining the term 'income of the trust estate' by using tax concepts was the preferred approach in submissions received in response to that discussion paper.
November 2011	The Treasury's Proposals Paper entitled 'Extending the roll-over for exchange of units in a unit trust for shares in a company'	The Government proposed to extend the CGT roll-over for the exchange of units in a unit trust for shares in a company (Subdivision 124-H of the ITAA97) to provide roll-over where units in a unit trust undergoing a restructure are held as revenue assets or trading stock. This was welcomed by all stakeholder submissions, who also noted that it would be desirable to ensure

https://taxreview.treasury.gov.au/content/FinalReport.aspx?doc=html/publications/Papers/Final_Report_Part_2/chapter_b2-2.htm.

[82] "*The Australian Government asked the Review to consider a proposal to allow small, closely-held companies and fixed trusts the option to effectively be treated as partnerships for tax purposes. Under this approach, income and losses of the company or trust would be assigned to shareholders and beneficiaries regardless of whether they were distributed. The proposal received mixed support in submissions. The proposal has the potential to reduce the compliance burden for micro-enterprises, as the many sets of rules associated with the current separate entity treatment of companies and some elements of the treatment of trusts would not apply. For example, flow-through taxation would make redundant the deemed dividend rules relating to non-commercial loans from a company to shareholders. The proposal could also allow some multiple entity structures to be simplified.*": https://taxreview.treasury.gov.au/content/FinalReport.aspx?doc=html/publications/Papers/Final_Report_Part_2/chapter_b2-4.htm.

[83] https://static.treasury.gov.au/uploads/sites/1/2017/06/Discussion_paper_Improving_the_taxation_of_trust_income.pdf

[84] https://static.treasury.gov.au/uploads/sites/1/2017/06/Consultation_Paper_Modernising_Taxation.pdf

[85] "*After highlighting the current issues with the existing operation of the 'proportionate approach' the paper outlined three options to more closely align the definitions of the terms 'income of the trust estate' and 'net income of the trust estate' for tax purposes. These options involved defining the term 'income of the trust estate' by: • using tax concepts — similar to the concept of 'adjusted taxable income' used in the specific anti-avoidance rules introduced in TLAA No.5 2011; • using accounting concepts; or • retaining the current approach of relying on general trust law principles and the trust deed, but specifically including capital gains. The submissions received in response to that discussion paper indicated that the preferred approach to defining the term 'income of the trust estate' as part of a 'patch' model was to use tax concepts.*": https://static.treasury.gov.au/uploads/sites/1/2017/06/Consultation_Paper_Modernising_Taxation.pdf, 36.

		that there is a rollover for both CGT and 'ordinary' assessable income purposes.[86]
December 2011	Board of Taxation's Review of Tax Arrangements Applying to Collective Investment Vehicles	The Board made a total of 18 recommendations; 12 recommendations in relation to the introduction of an IMR for foreign managed funds, and 3 recommendations in relation to the taxation arrangements under the VCLP regimes, with a series of sub-recommendations. Relevantly, the Board recommended "*against the adoption of the MIT tax regime, as it taxes all CIVs as Trusts*"[87]
June 2012	The Treasury's documents released under a Freedom of Information request in relation to the Abolishment of the CGT trust cloning tax exception	These documents were released following a Freedom of Information request in relation to the retrospective abolishment of the CGT trust cloning tax exception to CGT Events E1 and E2, effective 1 November 2008.
July 2012	The Treasury's Discussion Paper entitled 'A more workable approach for fixed trusts'	This discussion paper was released after the *Colonial First State Investments Ltd v FCT* [2011] FCA 16 case and aims to explore options to provide greater certainty and reduce complexity for fixed trusts. Most relevantly, the following three issues remain unresolved in this context, as follows: definitional inconsistencies of 'fixed trusts' between Subdivision 126-G of the ITAA97 and Schedule 2F to the ITAA36;[88] issues arising in relation to CGT Event E4 not to applying to discretionary trusts pursuant to s104-72 of the ITAA97 (which is particularly problematic given that it is very unlikely that any trust could ever be said to be a 'fixed trust' if the *Colonial* interpretation is adopted, resulting in many trusts needing to rely on the Commissioner to exercise a discretion to be considered a fixed trust);[89] and, inconsistent outcomes for foreign residents under s855-40 ITAA97 by not being able to disregard a capital gain that arises from an asset that is not taxable Australian property if they hold the asset through a trust that is not a 'fixed trust' (or a chain of trusts where even one trust is not a 'fixed trust') even though they would have been able to disregard the gain if they held the asset directly.[90]
October 2012	The Treasury's Policy Options Paper entitled 'Taxing trust income – options for reform'	Following its November 2011 Proposals Paper, Treasury responded to the consultations by issuing this Policy Options Paper, which further articulates the design of two of its proposed models (the 'trustee assessment and deduction' model and the 'proportionate within class' model; renamed the 'economic benefits model' and the 'proportionate assessment model', respectively).
April 2015	The Treasury's consultation entitled 'A new tax system for managed investment trusts'	This consultation process aimed to create a new tax system for MITs by modernising the tax rules, increasing certainty and enhancing international competitiveness to promote the greater export of Australia's funds management expertise.
June 2017	Board of Taxation's Self-initiated Review of the Tax Treatment of Bare Trusts and Similar Arrangements	The Board's observation on the broad appeal of bare trusts include: "*[b]are trusts and similar arrangements are used widely in society by individuals, domestic and multinational businesses, and charities with almost $4.5 trillion in assets held via these arrangements by licensed custodians alone*".[91] The Board (making a total of 6 recommendations) recommended legislating to enable certain bare trusts (and arrangements with similar characteristics) to be looked through for most income tax purposes.

[86] https://static.treasury.gov.au/uploads/sites/1/2017/06/ICAA-2.pdf, 2.
[87] http://taxboard.gov.au/consultation/taxation-treatment-of-collective-investment-vehicles/
[88] https://static.treasury.gov.au/uploads/sites/1/2017/06/fixed_trusts.pdf, 6. While amendments have been introduced, they are focussed on MITs; see, the Explanatory Memoranda to *Tax Laws Amendment (New Tax System for Managed Investment Trusts) Bill 2015* (Cth): "*A managed investment trust that is an attribution MIT will be treated as a fixed trust for the purposes of the income tax law.*"; available at: https://parlinfo.aph.gov.au/parlInfo/download/legislation/ems/r5596_ems_97125705-bd6a-45f5-a485-bb122766e238/upload_pdf/504388.pdf;fileType=application%2Fpdf.
[89] https://static.treasury.gov.au/uploads/sites/1/2017/06/fixed_trusts.pdf, 20.
[90] https://static.treasury.gov.au/uploads/sites/1/2017/06/fixed_trusts.pdf, 22.
[91] https://cdn.tspace.gov.au/uploads/sites/70/2018/02/BoardofTaxation-FINAL-Review-of-Bare-Trusts.pdf, 3.