The Taxation of Capital gains in Trusts After *Bamford*:
Despite the complexity, are the 'interim' measures achieving their purpose?

The 2011 'interim' measures to the taxation of capital gains in trusts (in Subdivision 115-C ITAA97) were a response to the High Court's decision in *Commissioner of Taxation v Bamford* (2010) 240 CLR 481 ('Bamford').

In *Bamford*, the High Court clarified that a beneficiary's present entitlement to the 'income of the trust estate' in Division 6, Part III of the ITAA36 referred to the distributable income of the trust according to trust law concepts and the trust deed. Importantly, the court held that a beneficiary's proportion or percentage share of trust (distributable) income is also used to determine their share of the trust's taxable income (the so-called 'proportionate' approach). Under the *Bamford* 'proportionate' approach, as a beneficiary is allocated a percentage of the trust's total taxable income (which might include both ordinary income and capital gains), the government considered that the streaming of particular kinds of trust income to specific beneficiaries would not be tax effective, on the reasoning that a beneficiary's share of assessable income could comprise a 'blended amount of all different types of income and capital gains included in the trust's taxable income.'

The purpose of the 2011 'interim' amendments was to ensure that the streaming of capital gains (as well as franked distributions) to specific beneficiaries would be effective for tax purposes, and ostensibly, to address 'key anomalous outcomes' in the taxation of trust income said to be revealed by *Bamford*, as where a beneficiary is assessed for tax on amounts that are different to that which they are entitled to receive.

It was intended that the 'interim' measures be appraised after a broader review of the taxation of trusts. This has not yet taken place, and as some have suggested, the 'interim' measures appear to be permanent for the foreseeable future. Although the explanatory memorandum to the interim measures claim that they are intended to 'improve the taxation of trust income,' the provisions are extremely complex with numerous steps, some of which do not appear to be intuitive. In 2011, the Tax Institute suggested an 'inability to understand the law' among practitioners. Some years later, in 2015, A 'Trust Streaming Manual' published by CPA Australia described the provisions as 'causing significant confusion' among the membership. Reflective of the complexity of the provisions, leading Australian taxation texts have variously described the taxation of capital gains in trusts as either 'beyond the scope' of the relevant text or have replicated the explanatory memorandum in outlining the operation of the provisions.

This paper evaluates the 'interim' streaming regime against its professed objectives. It examines whether the streaming provisions are less likely to lead to anomalies compared with the previous law and other plausible alternatives, and also considers whether the statutory purpose of ensuring tax effective streaming could be achieved by means of a simpler process.

I INTRODUCTION

Amendments to the Australian income tax legislation in 2011, effective from the 2010-2011 income year, which aim to ensure that net capital gains and franked distributions can be effectively 'streamed' for tax purposes, have introduced significant complexity to the taxation of capital gains and franked distributions in trusts. This paper focuses on capital gains (similar observations and arguments apply to franked distributions, although specific issues concerning the same are not examined here). Although the provisions were described as 'interim,' and intended to be re-examined as part of a broader review of the taxation of trusts, more than seven years later, this has not taken place and may be here to stay for the foreseeable future.

The streaming regime in Subdivision 115-C of *the Income Tax Assessment Act* (ITAA97), and related amendments to Division 6 of the *Income Tax Assessment Act* 1936 (ITAA36) represent a vital component of the taxation of trusts in Australia. Notably, the 2011 provisions have altered the legislative basis on which net capital gains (and franked distributions) are taxed even where a trustee does not undertake streaming. Several new terms and concepts were introduced by the 2011 amendments. The intricate, complicated process of working out beneficiaries' (and trustees,' as the case may be) attributable capital gains (and franked distributions) under the current regime tends to obscure an understanding of its overall purpose. As an indicator of the inaccessibility of the current provisions, it is noted that several leading Australian taxation law textbooks either do not cover the regime, or simply replicate and rely on the explanatory memorandum without any substantial commentary or analysis of the provisions.[1]

The immediate impetus for the 2011 amendments was the High Court's decision in *Commissioner of Taxation v Bamford* ('Bamford').[2] *Bamford* confirmed two central propositions concerning the operation of section 97 ITAA36, which is the core provision that governs the assessable income of a beneficiary under a trust. Firstly, the High Court confirmed that the reference to a beneficiary's 'present entitlement' to the 'income of the trust estate' in section 97 ITAA36 refers to the conception of income under trusts law (and means distributable income), which in turn respects any variation of normal presumptions effected by the trust deed.[3] Secondly, as a matter of a matter of statutory construction, the High Court confirmed that a beneficiary is assessed for income tax under section 97 pursuant to the so-called 'proportionate' approach, which had been applied in earlier Federal Court decisions.[4] Under this approach, the same percentage share or proportion of distributable income to which a beneficiary is entitled under the principles of trust law, is also applied to the trust's taxable income to determine the beneficiary's income tax liability.[5]

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[1] E.g., Sadiq, Coleman, Hanegbi et al, *Principles of Taxation Law* (Thomson Reuters, 2018); Barkoczy, *Foundations of Taxation Law* (Oxford, 2018). A detailed (practitioner-oriented) coverage of the operations of the provisions is contained in Gaal, *Discretionary Trust Distributions* (3rd edition) (Tax Institute, 2013) Chapter 4 and 5. However, given the complexity of the streaming regime, many (aside from specialists in the area) may also consider this detailed treatment to be inaccessible. For academic analysis of the new provisions, which suggests a systematic method for approaching and applying the rules, see Dale Boccabella, 'Net capital gains of trusts: A systematic method of allocating those gains and other taxable income and analysis of problematic and anomalous issues' (2018) 47 *Australian Tax Review* 128.

[2] (2010) 240 CLR 481.

[3] Ibid 505-506 (French CJ, Gummow, Hayne, Heydon and Crennan JJ).

[4] The key previous decision which applied the 'proportionate' approach is *Zeta Force Pty Ltd v Commissioner of Taxation* (1998) 84 FCR 70 (Sundberg J). *Davis v Federal Commissioner of Taxation* (1989) 86 ALR 195 (Hill J) provides a further, earlier example.

[5] *Bamford* (2010) 240 CLR 481, 507-508 (French CJ, Gummow, Hayne, Heydon and Crennan JJ).

The Government considered that *Bamford* 'highlighted longstanding problems with the taxation of trusts,'[6] particularly that the amount on which a beneficiary is assessed for tax may be different to the amount that they are entitled to receive under trusts law.[7] The Government took the view that the 'proportionate' approach cannot be reconciled with an ability to stream capital gains to specific beneficiaries for tax purposes, on the reasoning that a beneficiary's percentage share of a trust's assessable income would include a 'blended amount of all of the different types of income and capital gains included in the trust's taxable income.'[8] The Federal Court's decision in *Commissioner of Taxation v Greenhatch,*[9] which was decided under the pre-2010/2011 law, is consistent with the Government's interpretation. The Government considered that the 2011 amendments 'address key anomalous outcomes and provide certainty in relation to the streaming of capital gains and franked distributions.'[10]

With the ultimate aim of evaluating the effectiveness of the regime, and obtaining a clear understanding of the perceived problem(s) it sought to tackle (and indeed whether a problem existed), this paper first examines the pre-2011 position and undertakes a detailed analysis of the 'proportionate approach' as conceptualised in *Bamford* and other cases. It considers whether the streaming of capital gains was unavailable under the proportionate approach (as claimed) by considering the application of the proportionate approach to key factual categories of interest. As will be outlined, while some cases of streaming could theoretically be accommodated under the proportionate approach, others cannot and it is thus concluded that legislative intervention was necessary to allow for the streaming of capital gains (and franked distributions). The paper then examines the significance and effectiveness of the 2011 streaming provisions by considering the application of the streaming regime and related amendments to key factual categories of interest i.e., situations where the capital gains are included in trust income and where they are not, and variations within these categories. It shows the extent to which practical consequences under the income tax legislation have changed (if any). Improvements and anomalies introduced by the amendments are identified. Although the Government stated (in the Explanatory Memorandum to the 2011 amendments) that it would defer the objective of achieving a better alignment of the concept of income under trusts law and the net income of the trust under tax law,[11] wherever applicable, this paper analyses the extent to which legislative provisions achieve this aspirational goal—this is not only of interest to the Government; the judiciary has recognised that a reasonable match between economic entitlements to trust income and the liability to taxation is a central and entrenched assumption underlying the taxation of trust income under Australian income tax legislation. As much as possible, the paper seeks to make the streaming regime accessible by highlighting its key concepts and identifying potential areas of confusion. Finally, the papers outlines areas of particular (and probably, unnecessary) complexity and provides some conceptual suggestions for improvement which may be of interest to regulators.

[6] Explanatory Memorandum to the *Tax Laws Amendment* (2011 Measures No. 5) Bill 2011 ('EM'), paragraph 2.7.
[7] Ibid.
[8] EM, at 2.9.
[9] [2012] FCAFC 84.
[10] EM 2.18.
[11] EM 2.14.

II Pre-2010/2011 Scheme for the taxation of trust income and the 'proportionate' approach under Section 97 ITAA36

Prior to the 2011 amendments, the scheme for the taxation of trust income could be discerned from the provisions of Division 6, Part III of the ITAA36.[12] From the 2010-2011 income year onwards, it is necessary to consider the ITAA97 alongside Division 6 ITAA36 in all cases where a trust (excluding managed investment trusts and certain other widely held trusts[13]) has either capital gains or franked distributions. Division 6E ITAA36 (inserted by the 2011 amendments) stipulates that these categories of income are assessed under Subdivision 115-C ITAA97 and Subdivision 207-B ITAA97 respectively.

A trust is not a legal person. The basic principle underlying Division 6 ITAA36 is that income generated by the trust is to be assessed in the hands of the beneficiaries or the trustee, and is ascertained by reference to the 'net income of the trust estate,' which essentially corresponds to the concept of taxable income. It is defined by section 95 ITAA36 to mean assessable income minus allowable deductions,[14] calculated as if the trustee was a resident.

The legislation contemplates that the liability to tax will primarily fall on the beneficiaries, and provides disincentives to accumulate income within the trust. In *Bamford*, the High Court began its discussion of Division 6 ITAA36 by noting that section 96 provides that the trustee shall not, except as provided by the legislation, be liable as trustee to pay income tax on the income of the trust estate.[15] The concept of a 'present entitlement' to trust income is critical as penalty rates of tax can be avoided in respect of income to which a beneficiary *is* presently entitled (either pursuant to s97 or s98[16]). A penal rate of tax (the highest individual marginal rate applied as a flat rate) applies under section 99A ITAA36 if there is net income of the trust to which 'no beneficiary is presently entitled,' unless the trust falls into one of the categories (principally, testamentary trusts) where the Commissioner is able to apply the (non-punitive) rates applicable to s99 ITAA36.

Section 97 ITAA36, the core provision governing the liability of beneficiaries to taxation, and the provision from which the 'proportionate' approach is derived, provides relevantly (in s97(1)) that:

> [w]here a beneficiary of a trust estate who is not under any legal disability is presently entitled to *a share of the income of the trust estate* the assessable income of the beneficiary shall include so much of *that share of the net income of the trust estate …* [emphasis added]

In *Bamford*, the High Court firstly confirmed that the legislative reference in s97 to a beneficiary being 'presently entitled to a share of the income of the trust estate' relies on principles of the general law of trusts, and accepted earlier High Court authority to the effect that this entailed a present legal right to demand payment of a share of trust income.[17] The High Court also stressed, consistently with trust law principles, that this meant a share of distributable income, after the

[12]While the ITAA97 still needed to be consulted in connection with beneficiaries' capital gains (and grossing this up, where applicable), net capital gains and franked distributions were brought to tax within Division 6 ITAA97.
[13]See the EM at 2.16.
[14]Except for deductions under s393 ITAA97 (farm management deposits), and in respect of any beneficiary who has no interest in the corpus of the trust estate, deductions under Division 36 ITAA97 (tax losses).
[15](2010) 240 CLR 481, 502.
[16]In certain situations where a beneficiary is presently entitled to trust income (including where a beneficiary is under a legal disability), as an administrative matter, section 98 requires the trustee to pay tax on behalf of the beneficiary (at rates applicable to the beneficiary).
[17] (2010) 240 CLR 481, 505. The principal authority relied on was *Harmer v FCT* (1991) 173 CLR 264.

trustee had met revenue outgoings.[18] Secondly, the Court concluded, relying on Sundberg J's judgment in *Zetaforce v Commissioner of Taxation*,[19] that a beneficiary's percentage 'share' of distributable income would also be applied to the trust's taxable income to ascertain the beneficiary's tax liability—this being the so-called 'proportionate' approach to the determination of a beneficiary's tax liability under s97.[20] The Court rejected the contention of the taxpayers that a beneficiary's taxable trust income would be limited to their trust distribution amount where the trust deed provided for a fixed monetary amount to the beneficiary (rather than a proportion of trust income). [21]

An analysis and critical evaluation of the proportionate approach, which has continuing relevance since the 2011 amendments, now follows. It is instructive to consider the Federal Court's detailed reasons in the *Bamford* litigation,[22] which were upheld in the High Court. At the outset, it is noted that the exact ascertainment of the 'income of the trust estate' according to trust law principles is essential for tax purposes as it is a vital input for calculating a beneficiary's tax liability under the proportionate approach. Emmett J outlined the key principle of relevance in the law of the trusts, which views the trustee's 'first duty' as being 'to comply with the terms of the instrument governing the relevant trust estate.'[23] Of relevance for present purposes, Emmett J stated that:

> Where the relevant trust instrument expressly stipulates the entitlement of particular beneficiaries by, for example, specifying that receipts that would be for capital account under the general law principles are to be distributed to life tenant beneficiaries, that provision prevails and determines the amount which the respective beneficiaries are entitled to receive.[24]

Accordingly, where the trust deed specifies that the trustee has the power to treat capital receipts as income available for distribution, and the trustee distributes such receipts to beneficiaries consistently with the trust deed, the beneficiaries are to be treated as presently entitled to those amounts for the purposes of section 97 ITAA36.[25] In *Bamford*, the trust deed conferred a broad re-characterisation power, giving the trustee an absolute discretion to treat a receipt as income or capital. This was held to be sufficient to treat a capital gain as income when the trustee purported to distribute it, even though no explicit determination was made by the trustee.[26]

In the Federal Court decision in *Bamford*, the court reiterated the view expressed in some earlier cases,[27] that a central policy objective of Division 6 ITAA36 is to ensure an appropriate relation between beneficiaries' distribution entitlements and their income tax obligations. As Emmett J puts it:

> An important assumption underlying Division 6 is that a beneficiary who derives a share of the net income should be in a position to pay the tax out of that income; otherwise, the beneficiary could be

[18] Ibid 506. The Court here relied on the Federal Court's decision in *Federal Commissioner of Taxation v Totledge Pty Ltd* (1982) 60 FLR 149.
[19] (1998) 84 FCR 70.
[20] (2010) 240 CLR 481, 507. For an early exposition of the proportionate approach, see *Davis v Federal Commissioner of Taxation* (1989) 86 ALR 195, 230 (Hill J).
[21] Ibid 507-508. This appeared to be a qualified version of the so-called 'quantum approach,' which as discussed later, has been the main theoretical contender to the proportionate approach.
[22] *Bamford v Commissioner of Taxation* [2009] FCAFC 66 (Emmett, Stone and Perram JJ).
[23] Ibid [52].
[24] Ibid.
[25] Ibid [58] (Emmett J).
[26] Ibid [62] (Emmett J).
[27] E.g., *Richardson v Federal Commissioner of Taxation* (1997) 150 ALR 167, 181(Merkel J).

> placed in a difficult position … as a general rule, liability for tax on receipts of a trust estate should correspond with the enjoyment of those receipts.[28]

The chief obstacle to meeting the policy objective of ensuring that the liability for tax corresponds with the 'enjoyment of trust receipts' are caused by discrepancies, in the individual case, between the trust's distributable income and the taxable income of the trust. However, this can be overcome to a significant degree (but not completely) by appropriate trust deed provisions (e.g., which provide that capital gains constitute part of distributable income, or even more effectively, by 'income equalisation' clauses which define distributable trust income as net tax income). As for unfairness or anomalies caused by the 'proportionate' approach to the determination of beneficiaries' tax liability (as conceptualised in *Bamford* and other decisions), two points can be noted. Where trust distributable income is less than taxable income, the proportionate approach leads to beneficiaries being taxed on amounts they may never be entitled to receive,[29] but, as noted, there is substantial scope to overcome this through the trust deed. A further source of dissatisfaction with the proportionate approach is that it has been held to imply an apparent inability to allocate or stream particular classes of income with distinct tax consequences (capital gains, franked distributions) to specific beneficiaries. A beneficiary that is allocated 40% of trust income is regarded as having a 40% share of taxable income, *which also corresponds to a 40% share of all the components of the income* (capital gains, ordinary income). An inability to stream particular classes of income does not entail an undermining of the central policy objective of Division 6 that there ought to be a correspondence between economic entitlements and taxable income. Rather, any dissatisfaction with an inability to stream arises from widespread acceptance of the viewpoint (shared by both taxpayers and the Government) that trustees *should* be able to strategically allocate capital gains (and franked distributions) so that particular beneficiaries can take advantage of the tax consequences associated with such distributions.

Before turning to consider scenarios with apparent unfairness, it is useful to first consider a simple scenario which is unaffected by the problems mentioned above. Suppose that a trust generates (only) rental income of $100,000 in a particular income year and this income is distributed to its two beneficiaries, A and B, with 40% to A and 60% to B. Here the total distributable income of $100,000 is the same as the trust's net income for tax purposes (the rental income being ordinary income under s6-5 ITAA97). For each of A and B, their distributable income corresponds with their taxable income, being $40,000 and $60,000 respectively.

Now suppose that the trust also has a (non-discountable) capital gain of $100,000 from the sale of property (in addition to the rental income of $100,000). Initially we will assume that there is no provision in the trust deed which enables the trustee to treat capital gains as income. On this basis, under ordinary trust principles, the income of the trust comprises only the rental income of $100,000. The net income for tax purposes under s95 ITAA36 is $200,000 ($100,000 rental income plus the $100,000 capital gain, which is statutory income, assessable pursuant to s102-5 ITAA97). Again assuming 40% of the trust income ($40,000) is distributed to A, and 60% to B ($60,000), under the proportionate approach, these same percentages that apply to distributable income are applied to work out each beneficiary's share of the trust's taxable income—this would be $80,000 to A (40% of $200,000), and $120,000 to B (60% of $200,000). We can note firstly that there is a fairness in the relative division of tax liability between the beneficiaries, being consistent with the ratio of their actual trust receipts (40% and 60% for A and B, respectively). There is however an apparent hardship in that the beneficiaries' taxable income exceeds their distributable income. This is not ultimately a

[28] *Bamford v Commissioner of Taxation* [2009] FCAFC 66 [56].
[29] *Davis v FCT* (1989) 86 ALR 195, 230 (Hill J).

consequence of the proportionate approach as such but lies in discrepancies between the concepts of distributable trust income and taxable income. In this case, where the discrepancy is due to a capital gain, the problem can be overcome by an appropriately drafted provision in the trust deed. This variation is now considered.

Continuing with the same scenario, but it is now assumed that the trust deed confers a power upon the trustee to treat any capital receipt as income, and the trustee proceeds to exercise that power. Then the distributable trust income and net taxable income are both $200,000, and the distributable and taxable income of A and B will be $80,000, and $120,000, respectively. The apparent unfairness in the previous scenario has been eliminated. It is common for trust deeds to specify that the distributable income of the trust corresponds to the trust's net income for tax purposes.[30] This is often framed as a 'default' provision, which is subject to any contrary determination by the trustee.[31] However, as the Commissioner indicates in tax rulings, it is not always possible for the trust deed to remove discrepancies between distributable trust income and net taxable income (e.g., franking credits are not regarded as part of trust income, even where an income equalisation clause in the trust deed purports to define trust income by reference to income tax concepts).[32]

Now consider the following variation to the scenario, where the trustee purports to distribute the capital gain in a different ratio to the ordinary income. This is where the proportionate approach leads to anomalies in the sense that it does not accommodate the reasonable intentions of the trustee. Suppose that the rental income is distributed 40% to A and 60% to B as in the previous scenario, but suppose that the trustee drafts a resolution which states that 70% of the capital gain is to be distributed to A and 30% to B. The trustee's motive for allocating 70% of the capital gain to A is to enable A to utilise a large personal capital loss to offset the capital gain. However, according to the assumed interpretation of the proportionate approach as conceptualised in *Bamford* and other decisions,[33] which is said to govern section 97 ITAA36, no effect can be given to the trustee's intention to distribute capital gains in a different ratio to other income: a beneficiary's percentage share or proportion of *total* distributable income equates to their percentage share of a trust's *total* taxable income, and it has further been concluded, as a necessary consequence, that the proportionate approach does not allow for any differential allocation of particular classes of income for tax purposes. The application of s97 to this scenario prior to the 2011 amendments is as follows. Assuming, as per the previous scenario, that the trustee is authorised to treat capital gains as distributable income, A's share of this distributable income is: $110,000 ($40,000 rental income plus the $70,000 capital gain) being 55%, and B's share is $90,000 ($60,000 rental income plus the $30,000 capital gain) being 45%. A's share of the trust's taxable income is also $110,000 (55% of $200,000) and B's share of the trust's taxable income is also $90,000 (45% of $200,000). In this example, A's allocation is treated as consisting of 55% of the rental income and 55% of the capital gain, and the trustee's intention to allocate or stream 70% of the capital gain to A is frustrated. The facts of *Bamford* did not actually raise this precise issue; however, an inability to differentially allocate (or stream) particular kinds of income for tax purposes does appear to be an implication of the proportionate approach as conceptualised by the courts, and as noted earlier, the Explanatory Memorandum relating to the 2011 amendments takes the position that the proportionate approach

[30] TR 2012/D1 [102]. For examples, see at [18]-[58] of this ruling.
[31] This was the case on the facts of *Bamford*.
[32] TR 2012/D1 [15], [24]-[29].
[33] The most direct consideration of the issue at hand is in *FCT v Greenhatch* [2012] FCAFC 84 [26]-[36] (Edmonds, Greenwood and Robertson JJ). Generally, as to the proportionate approach, see *Davis v FCT* (1989) 86 ALR 195, 230 (Hill J); *Zeta Force Pty Ltd v Commissioner of Taxation* (1998) 84 FCR 70, 74-75 (Sundberg J).

does not allow for the streaming of particular kinds of income.[34] The issue arose for direct consideration in the Federal Court's 2012 decision in *Greenhatch v Commissioner of Taxation*[35] ('*Greenhatch*'), which concerned the law prior to the 2011 amendments. Here the trustee exercised a power to treat a net capital gain as distributable income. The taxpayer beneficiary's share of the net income of the trust for tax purposes was $112,340. Consistent with the trustee's intention, the taxpayer argued that the entire $112,340 was referable to a net capital gain of approximately $225,000, which was included in the trust's taxable income of $598,564. The Tribunal accepted this conclusion, but it was overturned by the Federal Court, which held that only 37.6% of the taxpayer's taxable share of trust income was referable to the net capital gain, since this was the percentage or proportion it constituted of the trust's taxable income ($225,000/$598,564). The court held that this was a necessary consequence of the proportionate approach, and considered that the streaming of capital gains was not possible under Division 6 ITAA36.[36]

Is a different interpretation possible? And what would be ideal as a matter of legislation design?

Before turning to the 'solution' offered by the 2011 amendments, two issues are considered: 1) even under the assumed conceptualisation of the 'proportionate' approach—under which a beneficiary's percentage share of distributable income also equates to their percentage share of total trust taxable income—is a non-ability to stream an inevitable consequence as held in *Greenhatch*? 2) does the statutory language of section 97 ITAA36 permit any other construction than the 'proportionate approach' as conceptualised in *Bamford*?

(1) With regard to the first issue, there are some situations where streaming could be accommodated even under the assumed conceptualisation of the proportionate approach. If we return to the situation considered earlier where the trustee resolves to distribute 40% of the rental income ($40,000) and 70% of the capital gain to A ($70,000), as noted above, under the proportionate approach, A's 55% ($110,000/$200,000) proportionate share of distributable income also means that A's percentage share of taxable income is 55%. If trust distributable income equals the trust's taxable income (as it did in the most recent variation considered) then it *could* theoretically be held that A's $110,000 of taxable income comprises rental income of $40,000 and a capital gain of $70,000, consistent with the intention of the trustee. Here, to abide by the proportionate approach (in a global sense), it is not necessary that A's proportionate share of distributable income also determine their proportionate share of specific classes of income. In other words, where a trust's distributable income equals its taxable income streaming can be accommodated, while respecting the central tenet of the proportionate approach.

Another situation where the trustee's decision to allocate capital gains in a particular way is *necessarily* accommodated for tax purposes is where the trust income consists only of a capital gain (assuming it be can distributed under the trust deed), and this is true even if the taxable capital gain differs from the distributable capital gain.

However, there are cases where the streaming of capital gains cannot be accommodated within the proportionate approach. In generic terms, a common situation where this would be so is where the trust income consists of a capital gain and other (ordinary) income and the distributable trust income differs from the taxable trust income. Suppose again that the trust distributable income consists of $100,000 rental income and a $100,000 capital gain. The taxable trust income is $150,000 (assume the 50% CGT discount applies to reduce the capital gain to $50,000). If the trustee resolves

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[34] EM 2.9.
[35] *FCT v Greenhatch* [2012] FCAFC 84.
[36] Ibid [36].

to distribute 70% of the capital gain to A and 30% to B with the rental income being distributed 40% to A and 60% to B, from above, the percentage shares to distributable income are 55% and 45% respectively for A and B, and accordingly their percentage shares of taxable income are $82,500 (0.55*$150,000) and $67,500 (0.45*$150,000). Here, the trustee's intention to stream is effectively ignored—each party's portions of capital gains and ordinary income are derived from their overall percentage of distributable income (A's net capital gain and rental income amounts also each equal 55% of the trust net capital gain and trust rental income amounts—$27,500 (of the $50,000 net capital gain) and $55,000 (of the $100,000 rent) respectively, and the same analysis (using 45%) would apply for B). In this particular case, where the discrepancy between trust income and taxable income is due to the CGT discount, it can be overcome through a trust deed provision which equates distributable income with net tax income, and as noted above, streaming can then be theoretically accommodated. However, as also noted earlier, there will be situations where it not possible, as a matter of law, to equate the two concepts. Accordingly, it is concluded as did the court in *Greenhatch*, that the *Bamford*-style proportionate approach (pursuant to which the percentage share of distributable income determines the percentage share of trust taxable income) cannot be reconciled with the streaming intentions of the trustee.

(2) In light of the conclusion just drawn, it is now considered whether the particular formulation of the proportionate approach, which was confirmed in *Bamford*, represents the inevitable construction of s97 ITAA36. As noted earlier, the section provides that where a beneficiary is 'presently entitled' to '*a share of the income of the trust estate* the assessable income of the beneficiary shall include so much of *that share of the net income of the trust estate.*'

In relevant court decisions, the 'proportionate' approach has been conceptualised as a beneficiary's percentage share of *total* distributable income, which is then equated with a beneficiary's percentage share of *total* trust taxable income. This interpretation appears to represent quite a literal interpretation of the statutory language. The implication of this approach, i.e., the notion that the liability to tax should fall homogenously across different classes of income with distinct tax consequences (capital gains, franked distributions), leads to inconvenient results in practice when they are inconsistent with the intentions of the parties to the trust. Further, this inconvenience is not one that the legislature foresaw or intended. The provisions of Division 6 ITAA36 pre-date the regime which introduced the taxation of capital gains, and as Hill J commented in *Davis v FCT*[37] (in a statement also cited in *Bamford*) 'the scheme of Div 6 calls out for legislative clarification,' especially in light of its interaction with the capital gains regime.[38] Further, it is worth noting, as pointed out by Gaal, that the Explanatory Memorandum to the legislation introducing the taxation of capital gains assumed that the streaming of capital gains in trusts would be possible.[39]

In judicial decisions, the main comparator to the 'proportionate' approach examined is the so-called 'quantum approach,' which limits a beneficiary's share of taxable income to their trust distribution amount.[40] While such an approach most clearly gives effect to the interest in ensuring that tax liability corresponds with distributable income, it has been held to be unavailable as a matter of statutory construction. Here, a different version of the proportionate approach is suggested. *A* proportionate approach per se is not unreasonable—indeed, the basic idea that the extent of tax liability should increase in accordance with economic entitlements is both fair and consistent with the central assumption of both Division 6 ITAA36 and key aspects of the income tax legislation (e.g., the progressive rates for the taxation of individuals). However, ideally, if a

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[37](1989) 86 ALR 195.
[38] Ibid 230.
[39] Above n 1, 72.
[40] Ibid

proportionate approach is to be adopted, it should not be applied to total distributable income, but *differentially to distinct classes of income* (i.e., whenever a class of income has distinct tax consequences) whenever the trustee has shown an intention to allocate such classes of income in different proportions. In the example considered earlier, where the trust has $100,000 rental income and a $100,000 capital gain, and the trustee purports to distribute $40,000 of the rental income and $70,000 of the capital gain to A, the proportionate approach as applied to distinct classes of income would give effect to the trustee's intention—A's entitlement would not be calculated on a total basis (under which A would be allocated only 55% of the capital gain), but rather, 70% of the capital gain (and 40% of the rent) would directly flow to A.

This particular interpretation of the proportionate approach is admittedly not an obvious construction of section 97 ITAA36. It requires that a beneficiary's entitlement to a share of income of the trust estate be interpreted as applying to distinct classes of income whenever a trustee has shown an intention to differentially allocate particular classes of income among beneficiaries. It is now considered whether the 2011 amendments offer a reasonable and effective means of enabling the streaming of capital gains.

III Does the streaming regime introduced in 2011 offer an effective solution?

Following a consultation with relevant stakeholders, amendments to the taxation of trusts were introduced in March 2011.[41] The provisions are effective from the 2010-2011 income year onwards. In the Explanatory Memorandum, the Government makes clear that the amendments are a response to *Bamford,* and states that their 'primary purpose' is 'to ensure that, where permitted by the trust deed, the 'streaming' of capital gains and franked distributions to beneficiaries is effective for tax purposes.'[42] The relevant provisions are described as 'interim changes to improve the taxation of trusts,'[43] and are intended to be re-examined following a broader review of the taxation of trusts (which has not occurred to date). While stating that the amendments do not resolve all 'problems' and 'uncertainties' (these being unidentified), the Government expressed the view that the amendments 'address key anomalous outcomes' and 'provide certainty in relation to the streaming of capital gains and franked distributions.'[44]

The provisions are complex, and a significant time commitment is required grasp the way in which the streaming regime operates, and the way in which the amendments have changed the law.[45] The initial challenge is one of orientation and navigation—knowing what provisions are relevant to the circumstances of the trust, and where they are located in the income tax legislation.[46]

Division 6 ITAA36 remains of central importance, and is the starting point when considering the taxation of trusts. If the trust does *not* have any capital gains or franked distributions in an income year, it is only Division 6 that is relevant. The 'net income of the trust' (as defined in s95 ITAA36) is determined as it was prior to the 2011 amendments, and taxed to beneficiaries or the trustee as the case may be, pursuant to relevant provisions, particularly s97, s98, s99A and s99 ITAA36.

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[41]The changes were affected pursuant to the *Tax Laws Amendment (2011 Measures No. 5) Act* 2011.
[42] EM 2.25.
[43] This is the title to Chapter 2 of the EM which describes the relevant changes.
[44] EM 2.18.
[45] For useful guidance, see Gaal, above n 1, Chapter 4, especially at 4-480.
[46] Some guidance is provided by the 'simplified outline' in s95AAA ITAA36 of the relationship between Division 6, Division 6E ITAA36 and Subdivisions 115-C and 207-B ITAA97.

If the trust does have a net capital gain[47] or franked distribution in an income year (since 2010-2011), and provided the trust has taxable income, the amendments are relevant. Division 6E ITAA36 (inserted by the amendments) modifies the operation of Division 6 by excluding capital gains, franked distributions and franking credits from the assessing provisions in Division 6 ITAA36,[48] and these are instead assessed under Subdivision 115-C ITAA97 (capital gains) and Division 207-B ITAA97 (franked distributions).[49] To effect this transformation whereby the assessing provisions in Division 6 (in sections 97, 98, 99, 99A and 100 ITAA36) only apply to income excluding net capital gains, franked distributions and franking credits, Division 6E introduces three new terms: 'Division 6E income,' 'Division 6E net income,' and the 'Division 6E present entitlement to the income of the trust estate'[50]—they denote the familiar concepts of trust income (according to trust law concepts), trust taxable income and present entitlement to trust income (according to trust law concepts) *but with capital gains, franked distributions and franking credits removed in each case*. Where a trust has capital gains or franked distributions, it is the 'Division 6E net income' (i.e., taxable income excluding net capital gains, franked distributions and franking credits) that is brought to tax under Division 6 ITAA36. For example, to continue with the scenario introduced in the previous section, if a trust has $100,000 of rental income and a $100,000 capital gain, and 40% of the rental income is distributed to A and 60% to B, pursuant to Division 6E ITAA36 (which is applicable due to the existence of the capital gain), the 'Division 6E income' is $100,000 (the rental income) and the 'Division 6E net income' (taxable income) is also $100,000 (the rental income). As Division 6E is enlivened, the concepts in s97 ITAA36 are modified: it is the Division 6E present entitlement that is relevant, which for A is $40,000 (0.4*$100,000 rental income) and for B is $60,000 (0.6*$100,000 rental income). Under s97, A has a 40% share of the Division 6E income, and pursuant to the proportionate approach, this means it has a 40% share of the Division 6E net income of $100,000. Accordingly A's assessable amount under s97 is $40,000 (the same process would apply for B). The capital gain is dealt with under Subdivision 115-C ITAA97 and considered later.

To address a point of potential confusion: despite that net capital gains, franked distributions and franking credits are not assessed under Division 6 ITAA36, but under Subdivision 115-C ITAA97 and Subdivision 207-B, these items are *only excluded for the purpose of working out assessable amounts under Division 6*. They are not excluded for any other purpose—net capital gains, franked distributions and franking credits are still part of the section 95 ITAA36 concept of the 'net income of the trust,' and franked distributions (but not franking credits) and capital gains (depending on the trust deed) may form part of the 'income of the trust estate,' and accordingly may constitute part of the income to which a beneficiary is presently entitled.[51] It is important to note this—as outlined below, these concepts are key inputs into formulas used in the taxation of capital gains in Subdivision 115-C ITAA97.

And despite that the main purpose of Subdivision 115-C ITAA97 is to allow for the streaming of capital gains, the approach of the legislation is to assess beneficiaries in respect of net capital

[47] That is, after applying steps 1-4 of the method statement in s102-5 ITAA97 (i.e. offsetting capital losses, applying applicable CGT discounts): s102UW (b)(i) ITAA36.

[48] Specifically, as stated in section 95AAA ITAA36, Division 6E excludes amounts relevant to capital gains, franked distributions and franking credits 'from the calculations of assessable amounts under sections 97, 98, 99, 99A and 100'.

[49] See section 95AAA ITAA36; see also EM 2.26. With respect to trustee assessments in respect of net capital gains, Subdivision 115-C ITAA97 (in s115-222 and s115-220) directs the assessment back to s99A or s99 (where there is trust income to which no beneficiary is presently entitled, or where the trustee has a specific entitlement amount pursuant to s115-230ITAA97) or s98 (i.e., in a situation where the trustee pays tax on behalf of the beneficiary).

[50] See section 102UY of Division 6E for the full definitions.

[51] This is made clear in s102UX ITAA36 (see especially the Note to s102UX(1) which explicitly states the same). See also s95AAA ITAA36 and the EM at 2.151.

gains entirely under Subdivision 115-C[52] whether or not streaming has been attempted by the trustee. This point is emphasised as it is a further confusing aspect of the legislation.

Two concepts can be focussed on as a means of understanding the streaming regime: 1) specific entitlement – the legislative term which describes when streaming is effective for tax purposes and 2) the 'adjusted Division 6 percentage' – this is a formula which allocates capital gains and franked distributions to which no beneficiary is specifically entitled. Here, the focus will only be on capital gains.

These key concepts feed into the core provision in section 115-227 ITAA97, which provides that a beneficiary's (or trustee's) 'share' of a capital gain is the sum of:

(a) the amount of the capital gain to which they are specifically entitled; and
(b) their proportionate share of any capital gain to which no entity is specifically entitled—this proportionate share is calculated using the 'adjusted Division 6 percentage.'

This 'share' is then used to work out the beneficiary's or trustee's 'attributable gain' under section 115-225 ITAA97: the 'share' expressed as a percentage of the amount of the trust's capital gain is multiplied by the amount of the trust's net capital gain.[53] Following this process, the remaining provision to be considered is s115-215 ITAA97, which requires beneficiaries to reverse or 'gross up' the effect of any CGT discounts applied at the trust level. Personal capital losses can then be applied first, and if available (as in the case of individuals), the CGT discount can then be claimed. The concepts of 'specific entitlement' and the 'adjusted Division 6 percentage' are now examined before turning to the application of the provisions to situations with and without the streaming of capital gains.

Streaming – Specific Entitlement

Pursuant to s115-228(1) ITAA97, a beneficiary has a 'specific entitlement' to some or all of a capital gain where the beneficiary 'has received or can reasonably be expected to receive' part or all of the net financial benefit referable to the capital gain, and where the amount 'is recorded, in its character as referable to the capital gain' in the accounts or records of the trust no later than 2 months from the end of the income year.[54] Clear evidence of an intention to make a beneficiary *presently entitled* to a capital gain (or part thereof) is sufficient for the purposes of 'specific entitlement.'[55] However, somewhat counter-intuitively, it is possible to make a beneficiary specifically entitled to a capital gain even when capital gains are not part of the distributable income of the trust[56] provided that the trust deed allows the trustee to stream capital gains.[57]

[52] However, where there is a net capital gain which to some or all extent is assessed to the trustee, Subdivision 115-C ITAA97 directs the trustee assessment back to Division 6 ITAA36— either s99A (or s99) (where there is trust income to which no beneficiary is presently entitled or where the trustee has a specific entitlement under s115-230 ITAA97) or s98 (where the trustee is paying tax on behalf of a beneficiary).
[53] That is, after applying steps 1-4 of the method statement in s102-5 ITAA97 (i.e. offsetting capital losses, applying applicable CGT discounts).
[54] Where proceeds relating to a capital gain have not been applied to a beneficiary within 2 months of the end of the income year, it is possible for a trustee to be specifically entitled to a capital gain under s115-230 ITAA97. The requirements under that provision must be followed. If the trustee is specifically entitled, the assessment occurs pursuant to s99A or s99 ITAA36.
[55] EM 2.45.
[56] See example 2.8 in the EM.
[57] EM 2.35.

The legislative formula in s115-228(1) ITAA97 for calculating specific entitlement is as follows:

Capital gain * share of net financial benefit/net financial benefit

For example, suppose a $150,000 capital gain is made from the sale of a trust asset, where there is a $10,000 carry forward capital loss that can be applied to reduce the capital gain. The trustee declares that a particular beneficiary is entitled to $110,000 of the capital gain. Here the beneficiary's specific entitlement is as follows:

> 150,000 (capital gain) *110,000 (share of net financial benefit) /$140,000 (net financial benefit, i.e. after subtracting the capital loss) = $117,857.14.[58]

In the more straightforward scenario where the trustee resolves to distribute all of the net financial benefit to the beneficiary, the specific entitlement will simply be $150,000 ($150,000 * $140,000/$140,000).'[59] Importantly, the requirement that the amount be 'recorded in its character as referable to a capital gain' means that it is insufficient for activating specific entitlement that a beneficiary is entitled to a proportion of an unspecified class of income, e.g., a proportion of the 'balance of trust income,' even where it contains capital gains that are part of distributable income. [60] Evidence of a deliberate attempt to allocate part or all of a capital gain is needed. This does not necessarily require the drafting of an appropriate resolution for the relevant income year. The Explanatory Memorandum to the amendments indicates that a trust deed that specifies that a beneficiary is entitled to all the capital gains in the trust is sufficient to create a specific entitlement.[61] Analogously, it would appear that a trust deed which states that a beneficiary is entitled to a definite proportion or percentage of capital gains ought to be sufficient.

The Adjusted Division 6 Percentage

As noted above, the 'adjusted Division 6 percentage' is the formula prescribed for allocating capital gains which are not the subject of specific entitlement. Broadly, this is allocated based on beneficiaries' present entitlement to trust income (disregarding specific entitlements). If there is trust income to which *no beneficiary is presently entitled*, then the trustee has an adjusted division 6 percentage,[62] and will be liable to tax (under s99A or s99 ITAA36).[63] The 'adjusted Division 6 percentage' is central to the operation of subdivision 115-C ITAA97, but its definition is contained in s95 ITAA36. It is to be contrasted with the 'Division 6 percentage,' also defined in s95. Both of these terms were introduced by the 2011 amendments.

It is appropriate to begin with the 'Division 6 percentage.' This is defined under s95 ITAA36 to mean the percentage share of the income of the trust estate to which a beneficiary is presently entitled. It can be expressed as follows:

Beneficiary's share of distributable income / Total distributable income

[58] This is part of a longer example from ATO webpages: https://www.ato.gov.au/General/Trusts/In-detail/Distributions/Streaming-trust-capital-gains-and-franked-distributions/?page=9
[59] The EM provides an analogous example at 2.45.
[60] See section 95 ITAA36.
[61] See the EM 2.65.
[62] See the EM 2.65.
[63] See the EM 2.82.

It is apparent that this is the key input under the *Bamford* proportionate approach, which views a beneficiary's percentage share of distributable income as also defining a beneficiary's assessable income (after the same percentage is applied to total trust taxable income). Since the 2011 amendments, the proportionate approach in this form is applied to calculate the tax liability of beneficiaries under Division 6 ITAA36 where there is no net capital gain or franked distribution, and in cases where there are net capital gains or franked distributions, is used to calculate tax liability in respect of balance trust net income excluding net capital gains and franked distributions, which as noted, is termed the 'Division 6E net income.' On the basis of judicial decisions (notably, *Bamford*) we know that the Division 6 percentage is the proportionate approach which is used to calculate tax liabilities under Division 6. However, curiously and confusingly, while the Division 6 percentage is a defined as described in s95 ITAA36, it is not explicitly presented in other provisions as a basis for calculations. Its main purpose appears to be as a conceptual construct—which is used to define the 'adjusted Division 6 percentage,' which *is* used in calculations, as now outlined.

The 'adjusted Division 6' percentage varies the Division 6 percentage by creating a default allocation which disregards specific entitlements (if applicable) as shown below. The varied formula[64] is as follows:

$$\frac{\text{Beneficiary's share of trust distributable income – their specific entitlement (if any)}}{\text{Trust distributable income – all specific entitlements (if applicable)}}$$

The application of Subdivision 115-C to key factual situations of importance in practice is now considered, and a comparison with the previous law also undertaken.

Key Scenarios

For the purpose of analysing and evaluating the application of Subdivision 115-C, it is useful to consider the application of the provisions to situations where capital gains are part of distributable income and when they are not. As noted, pursuant to general principles of the law of trusts, capital gains are not part of distributable income. However, trusts law recognises that this general presumption can be varied either through a trust deed provision, or pursuant to a power conferred by the trustee to re-characterise receipts.

(A) Capital gains are part of trust income.

(i) Trustee does not undertake streaming—'proportionate approach' continues to apply

Returning to the basic scenario considered earlier, where a trust has \$100,000 rental income and a \$100,000 capital gain (which is included in distributable income) with two beneficiaries, A and B (initially, assume the capital gain is non-discountable). In a particular income year, the trustee declares that 40% of the trust income is to be distributed to A and 60% to B.

Here, the distributable income of the trust estate comprises \$200,000, and the trust's total taxable income (the section 95 ITAA36 net income of the trust) is also \$200,000. The trustee has made no attempt to stream any part of the capital gain (i.e., there are no specific entitlements)—the

[64] See the EM 2.73.

assessable amounts will be the same as the pre-2011 law *but the relevant process and provisions are different*.[65]

Division 6E ITAA36 takes the capital gain out of the assessing provisions of Division 6. The net taxable income assessed under Division 6 (the 'Division 6E net income') is $100,000 and each of A and B are assessed on $40,000 and $60,000 respectively under s97 ITAA36. The net capital gain is assessed under Subdivision 115-C ITAA97. The adjusted division 6 percentage is used to determine each beneficiary's proportionate share of the capital gain to which no beneficiary is specifically entitled. Here, application of the formula yields the same results as the *Bamford*-style 'proportionate approach,' as there are no specific entitlements at all. For example, for A:

$$\frac{\text{\$80,000 (A's present entitlement to trust income, i.e. 40\% * \$200,000) – 0 (A has no specific entitlement)}}{\text{\$200,000 (total distributable income) – 0 (no beneficiary has any specific entitlements)}}$$

i.e., this is $80,000/$200,000, which is 40%, and is applied to the capital gain of $100,000 to obtain A's share of the capital gain, which is $40,000. Applying the same formula, B's share is $60,000. Combining each beneficiary's Division 6 amount with their assessable capital gain under Subdivision 115-C gives $80,000 for A and $120,000 for B respectively—being the same results as under the pre-2011 law.[66]

If the capital gain was discountable, the results are also the same as the pre-2011 law. In that case, the trust's taxable income would be $150,000 ($100,000 rental income + $50,000 capital gain). The adjusted Division 6 percentage applied to the capital gain would lead to A being allocated $20,000 (40% of $50,000) and B being allocated $30,000 (60% of $50,000)—again, simply being an application of the proportionate approach. This is so whether or not the trust's taxable income includes the discountable portion of the capital gain (and is $200,000) or if it is defined to equal net tax income (and is $150,000)—it is the beneficiaries' percentage entitlements to distributable income (which are constant) that determine their share of the taxable capital gain.

What if the trust income consisted only of the capital gain? Again, the same results would apply as under the pre-2011 law, with the proportionate approach being applied to allocate $40,000 of the capital gain to A and 60% to B. Prior to the amendments, a chief advantage of defining trust income (under the trust deed) to include capital gains was to avoid the imposition of penalty tax in s99A ITAA36 which would otherwise (potentially) apply in the situation where there was a net capital gain but no trust income (and accordingly no beneficiary who could be presently entitled to income). As discussed below, since the amendments, s99A ITAA36 can be more easily avoided by making beneficiaries specifically entitled to capital gains even where capital gains are not included as part of trust income (provided the trustee has a power to stream capital gains under the trust deed).

(ii) The trustee undertakes streaming (entirely)

Continuing with the same scenario, assume that the trustee allocates the capital gain (which is included in trust distributable income) in a different ratio to the ordinary income: 70% to A and 30% to B (whereas the other (rental) income is distributed 40% to A and 60% to B). Note that the capital gain is fully streamed (there is no capital gain to which no beneficiary is specifically entitled). As noted above, prior to the 2011 amendments, both the Government and the Federal Court in

[65] See the EM 2.29.
[66] See TR 2012/D1 Example 4 at para 36 for a longer example which is materially similar.

Greenhatch did not consider that different classes of income could be allocated differently for tax purposes as a consequence of the 'proportionate approach,' which was held to govern s97 ITAA36 in *Bamford*.

Under the current law, which allows for streaming through the mechanism of creating 'specific entitlements' (as described above): the trustee's intention can be given effect. Division 6E ITAA36 takes the capital gain out of the assessing provisions of Division 6, and it is assessed under Subdivision 115-C ITAA97, pursuant to which A would have a $70,000 share of the capital gain and B would have a $30,000 share. If it is assumed that there are no trust losses to reduce the gain, and that it is non-discountable, these amounts are the same as their attributable gain based on the trust's net capital gain. The other (rental) income is assessed under Division 6, based on beneficiaries' proportionate share to trust income excluding capital gains and franked distributions. On this basis, A's total trust assessable income would comprise the $70,000 capital gain and the $40,000 rental income, and B's total trust assessable income would comprise the $30,000 capital gain and $60,000 rental income.

As outlined above, prior to the 2011 amendments, based on the assumed interpretation of the 'proportionate approach,' the beneficiaries' percentage share of distributable income determined their share of taxable income (with that same percentage being applied to each class of income with no possibility of allowing for a different percentage for any particular class of income) [67] Accordingly, as A's percentage share of distributable income is 55% in this example ($40,000 rental income + $70,000 capital gain, being $110,000/$200,000), their share of the capital gain would also be 55% or $55,000, which frustrates the intention of the trustee—as discussed above, there are strategic tax reasons for allocating capital gains differently to other (ordinary) income—e.g., here if A has a personal capital loss of $70,000 or more, this can be used to offset the $70,000 capital gain such that A does not recognise a net capital gain for tax purposes. The current law enables this objective to be achieved.

(iii) The trustee undertakes streaming of part of the capital gain[68]

Continuing with the same basic scenario where a trust has $100,000 in rental income and a $100,000 capital gain (which is included in distributable income): under the trust deed, assume that A is entitled to 40% of the distributable income and B is entitled to 60%. Assume here that the trustee only explicitly allocates part of the capital gain: 70% is allocated to A by an appropriate resolution, but the remainder is not explicitly allocated. If we assume that the net financial benefit attributable to the capital gain is $100,000, then A's specific entitlement to the capital gain is the same as their allocation and is $70,000. The capital gain to which no beneficiary is specifically entitled is $30,000. This is allocated to beneficiaries based on their 'adjusted Division 6 percentage.' To input into this formula, we need A's present entitlement to trust income, which is $80,000 (40% of $200,000), and B's present entitlement to trust income, which is $120,000 (60% of $200,000).

[67] See *Greenhatch* [2012] FCAFC 84 [36] (as discussed above, the decision concerned the pre-2011 provisions).
[68] ATO webpages contain an analogous example to that outlined in this section at https://www.ato.gov.au/General/Trusts/In-detail/Distributions/Streaming-trust-capital-gains-and-franked-distributions/?page=9 However, that example considers the capital gain, but does not work through to determining the total trust assessable income of each beneficiary—that whole process is attempted in this section.

A's and B's adjusted Division 6 percentage is as follows:

For A:	For B:
$80,000 (A's present entitlement to trust income) - $70,000 (A's specific entitlement) / $200,000 (total distributable income) - $70,000 (any specific entitlements)	$120,000 (B's present entitlement) – 0 (B's specific entitlement) / $200,000 (total distributable income) - $70,000 (any specific entitlements)
$10,000 / $130,000	$120,000 / $130,000
= 7.69%	= 92.31%
$2,308 - A's share of the capital gain to which no beneficiary is specifically entitled (0.0769*$30,000)	$27,692 - B's share of the capital gain to which no beneficiary is specifically entitled (0.9231*$30,000)

A's share of the total capital gain comprises $70,000 (to which they are specifically entitled) + $2,308 = $72,308 or 72.31%. B's share of the total capital gain is $27,692 or 27.69%. Assuming CGT concessions do not apply, these shares are also equivalent to the attributable gain of each (based on the trust's net capital gain).

As for the division of the rental income and each party's assessable income in respect of this pursuant to s97 ITAA36, it is necessary to work out their 'Division 6E present entitlement' to the Division 6E trust income (which excludes capital gains and franked distributions), which is then applied to the Division 6E net income (trust taxable income stripped of net capital gains and franked distributions) to work out their individual trust taxable income under Division 6. It is first necessary to consider the trust law position. Given that A was explicitly allocated $70,000 of the capital gain (with no further explicit allocations made), to comply with the trust deed provision that A and B be allocated 40% and 60% of distributable income, in relation to the balance trust income of $130,000, A must be allocated a further $10,000 (taking their distribution to $80,000, which is 40% of $200,000) and B must be allocated $120,000 (which is 60% of $200,000). For the purpose of s97 (which does not assess the capital gain), the rental income and capital gain components need to be identified. There is $100,000 rental income embedded in the balance trust income of $130,000. Since the rental income is 76.92% of the balance trust income ($100,000/$130,000) and the capital gain is 23.08% ($30,000/$130,000), then applying these proportions rateably, with respect to A's present entitlement to a further $10,000, this comprises rental income of $7,692 (76.92% of $10,000) and a further capital gain amount of $2,308 (23.08% of $10,000). In passing, it is noted that the capital gain amount in the balance trust income outlined here corresponds (as it should) with that worked out using the legislative formula (which assigns proportions of the capital gain to which no beneficiary is specifically entitled). With B's present entitlement to $120,000, this comprises rental income of $92,308 (76.9230% of $120,000) and a capital gain amount of $27,692 (23.0769% of $120,000).[69] As A is entitled to $7,692 of the distributable rental income of $100,000, this percentage of 7.692% also determines their proportionate liability to the adjusted (Division 6E) net

[69] Numerous decimal places are used here to show that the capital gain (in the balance trust income) is the same as the capital gain amounts to which no beneficiary is specifically entitled (calculated earlier, using the legislative formula).

income of the trust, which is also $7,692. As B is entitled to $92,308 of the distributable rental income, their proportionate liability to the adjusted (Division 6E) net income is 92.308%, which is also $92,308.

A's total trust assessable income is $72,308 (capital gain) + $7,692 (Division 6 income), which equals $80,000, and B's total trust assessable income is $27,692 (capital gain) + $92,308 (Division 6 income), which equals $120,000.

It can be seen that the parties' liability to tax corresponds with their economic entitlements. The result seems equitable but the process is rather complicated.

(iv) What if there is income to which no beneficiary is presently entitled?

If the trustee fails to allocate any of the distributable income, there will be income to which no beneficiary is presently entitled, and as was the case prior to the amendments, the trustee will be liable to tax either under s99A ITAA36 (at a penalty rate), or s99 ITAA36 (in limited circumstances). If the income to which no beneficiary is presently entitled includes part or all of a capital gain, Subdivision 115-C ITAA97 will apply to assess the trustee on the capital gain (the trustee will have an adjusted Division 6 percentage[70]), which has the effect of creating (or increasing) the liability of the trustee under s99A ITAA36 or s99 ITAA36.[71]

(B) *Capital gains are not part of trust income*.

(i) Trustee does not undertake streaming

Continuing with the same basic scenario, assume that the trust has rental income of $100,000 and a capital gain of $100,000 but that the trust deed does not define income such that (pursuant to ordinary trust law principles) the capital gain is not part of the distributable income of the trust. Under the trust deed, A is entitled to 40% of the trust's income and B is entitled to 60%. Assuming the trustee distributes all of the trust income (i.e., the rental income), then A and B will be liable to tax on the trust's net capital gain in accordance with the same proportions and the result is the same as the pre-2011 law (although different provisions apply).[72] The apparent hardship of beneficiaries facing a tax liability in respect of income which they will not receive can be more easily overcome under the present law by making beneficiaries specifically entitled to the capital gain (as discussed in (ii) below).

(ii) Trustee undertakes streaming (entirely)

Even in the situation where the trust deed does not specify that capital gains are part of trust distributable income, the legislation contemplates that capital gains may be streamed to beneficiaries (provided the trustee has the power to stream capital gains under the trust deed).[73] In the factual situation described in (i) immediately above, the trustee could choose to distribute the

[70] In respect of capital gains to which no beneficiary is specifically entitled, where the beneficiaries' adjusted Division 6 percentages do not add up to 100%, the difference is the trustee's adjusted Division 6 percentage. Necessarily, this will only arise where some or all of the capital gain is not the subject of present entitlement.
[71] See 2.101 of the EM.
[72] See Gaal, above n1, 238 (Example 1) for a further example which is similar in key respects (the trust contains no definition of income such that capital gains are not included in trust income, the trust has positive income which is fully distributed, and there is a net capital gain which is not the subject of streaming).
[73] EM 2.87.

capital gain to one or both beneficiaries. If all of the capital gain is streamed, the analysis is fairly straightforward. For example, if the trustee resolves to allocate 70% of the capital gain to A and 30% to B, each party would have a $70,000 and $30,000 share of the trust's capital gain pursuant to Subdivision 115-C (these would also be their attributable gains based on the trust's net capital gain if the trust had no capital losses, and CGT concessions did not apply).

Compared to the pre-2011 law, the current law confers a definite advantage insofar as it enables the trustee to pass on the tax consequences associated with capital gains to beneficiaries even if capital gains are not part of trust income. This will be particularly advantageous where the trust has no trust income, but has a net capital gain for tax purposes. Prior to 2011, the trust faced the prospect of penalty rates of tax under s99A ITAA36 here—since it was necessarily not possible to make beneficiaries presently entitled to any trust income (in the situation where the trust deed did not include capital gains as income).[74] Since 2011, this undesirable consequence can be avoided by invoking the specific entitlement procedure.

(iii) Trustee undertakes streaming (partially)

Here the factual situation described immediately above is varied to examine the position where part of the capital gain is not streamed, where the analysis is more complicated.[75] Suppose that 70% of the capital gain is streamed to A as before, but the remainder is unallocated. There is therefore a capital gain of $30,000 to which no beneficiary is specifically entitled, and for tax purposes, this will be allocated to beneficiaries in accordance with their 'adjusted Division 6 percentage.' This formula inputs A's and B's present entitlement to trust income, which here is assumed not to include capital gains (under the trust deed), and comprises 40% and 60% of the rental income (of $100,000) respectively. Importantly, the legislation only excludes specific entitlements to the extent that they formed part of trust income in the first place,[76] and so A's specific entitlement is not excluded here as capital gains are not part of trust income. The calculation is as follows:

For A:	For B:
$40,000 (Present entitlement to trust income) – 0 (their specific entitlement – zero, as not part of distributable income)	$60,000 (Present entitlement to trust income) – 0 (their specific entitlement)
$100,000 (Trust income) - 0 (all specific entitlements – zero, as not part of distributable income)	$100,000 (Trust income) – 0 (all specific entitlements – zero, as not part of distributable income)
40 / 100 = 40%	60/100 = 60%

Here, A's and B's proportions of the unallocated part of the capital gain (which is not the subject of specific entitlement) is determined by their proportionate entitlements to trust income (as defined in the trust deed). This approach is somewhat anomalous here given that the use of the specific entitlement mechanism *has in fact varied the economic entitlements* of the beneficiaries. To ensure that liability to tax is in proportion to the parties' economic entitlements, the parties' new economic entitlements should be calculated (based on the amount explicitly allocated – this is $170,000 i.e.

[74] On this point, see Gaal, above n 1, 54.
[75] See Example 2.8 in the EM which works through a scenario analogous to that described here; see also Gaal, above n 1, 95 which provides a further example which is similar in key respects (the trust does not define income such that capital gains are not included, the trust has a positive income which is fully distributed, and there is a net capital gain, with the capital gain being partially the subject of specific entitlement).
[76] See 2.72 of the EM.

$100,000 rental income plus the $70,000 to which A is specifically entitled) and these proportions used to calculate beneficiaries' respective allocations in respect of the capital gain to which no beneficiary is specifically entitled. Using this approach, A's varied entitlement is $40,000 (share of the income of the trust estate) plus $70,000 (specific entitlement) i.e., $110,000, which gives a proportionate share of 64.7% ($110,000/$170,000) in respect of the capital gain to which no beneficiary is specifically entitled, and B's proportionate allocation is 35.3% ($60,000 (rental (trust) income/$170,000).

(iv) What if there is income to which no beneficiary is presently entitled?

The position is essentially the same as the pre-2011 law and also the same as in (A)(iv) above where the trust deed does include capital gains as income. The trustee will be assessed under s99A ITAA36 (or s99 ITAA36, in limited circumstances) in respect of income to which no beneficiary is presently entitled. As mentioned above, if the trust taxable income includes a capital gain to which no beneficiary is presently entitled, Subdivision 115-C ITAA97 has the effect of creating (or increasing) the liability of the trustee under s99A ITAA36 (or s99 ITAA36). Unless there are particular reasons why the trustee wishes to be assessed, the prospect of penalty rates of tax under s99A ITAA36 can be easily avoided by invoking the special entitlement procedure.

IV Evaluation of the Regime

A *Practical Consequences*

Putting the complexity aside for a moment, the 2011 amendments do achieve the legislature's 'end purpose' of enabling the streaming of capital gains (and franked distributions), and removing the post-*Bamford* uncertainty as to whether streaming was possible.[77] As noted earlier, and as confirmed by the Federal Court in *Greenhatch*, the 'proportionate approach' to the assessment of a beneficiary's tax liability under s97 ITAA36 (when it is conceived as a fraction of *total* distributable income that is applied to total trust taxable income) cannot be reconciled with the notion that different classes of income can be allocated (for tax purposes) in different ratios. This is possible pursuant to the new provisions: by invoking the specific entitlement mechanism, a trustee can allocate a particular percentage of capital gains to a beneficiary (e.g., 70%), which can be different to the percentage of other income that the beneficiary is allocated (e.g., 40%).

In terms of other favourable practical consequences of the amendments, as outlined above, penalty rates of tax under s99A ITAA36 can be more easily avoided in the situation where capital gains are not included as part of trust income and the trust income is nil. Even where capital gains are not included in trust income, the trustee can invoke the special entitlement mechanism to stream capital gains to beneficiaries (such that beneficiaries bear the tax consequences associated with the net capital gain). Previously, to avoid s99A ITAA36, it was essential that capital gains either be included as part of trust income (or that the trustee had a power to re-characterise receipts) in the situation where the trust's only taxable income consisted of a net capital gain (otherwise, there would necessarily be no income to which a beneficiary could be presently entitled).

The apparent hardship that arises where a beneficiary's taxable income exceeds their distributable trust income can still arise under the new provisions—for example, as in the situation

[77] See Gaal, above n 1, 75 where a similar view is expressed.

(b)(i) above where trust income does not include capital gains, but beneficiaries are assessed on a net capital gain included in the trust's taxable income. However, as under the old law, there is large scope for parties to overcome this problem through drafting appropriate trust deed provisions. Furthermore, the new provisions in this respect mitigate this apparent unfairness—even where capital gains are not included as part of trust income under the trust deed, the trustee can invoke the special entitlement mechanism to allocate capital gains to beneficiaries for tax purposes (provided the trust deed contains a streaming power), so as to enable a closer correspondence between beneficiaries' economic entitlements and their taxable trust income.

However, as outlined above, the amendments appear to have created a significant anomaly in the situation where the trust deed *does not include capital gains as income*, and the trustee creates a *partial* specific entitlement to the capital gain. Here, as shown above (in example b(iii)) the tax liabilities of beneficiaries are not in proportion to their economic entitlements. In relation to the relative division of tax liability among beneficiaries with respect to the capital gain which is not the subject of specific entitlement, it seems inequitable that it is determined by beneficiaries' proportionate shares to trust income—the legislative formula does not take account of the fact that use of the specific entitlement mechanism has *in fact* varied the distributable economic entitlements of the parties.

B *Legislation Design – Complexity*

As the analysis in this paper indicates and as others have also concluded, the regime introduced by the amendments is exceedingly complex. Very probably, a streaming regime could be designed without the high level of complexity which currently impedes an understanding of the provisions. As outlined in the paper, some of the chief areas of complexity are as follows:

- At a conceptual level, the fact that *all* net capital gains are stripped out of Division 6 ITAA36 and are assessed under Subdivision 115-C ITAA97 *even when streaming is not undertaken* and the outcomes are the same as under the previous law (pursuant to the *Bamford*-style proportionate approach). This scenario is analysed through the lens of specific entitlement (namely, a complete absence of specific entitlement). The 'adjusted Division 6 percentage' is the legislative basis for allocation of capital gains here even though it is conceptually unnecessary;
- The legislation's use of *closely-related but distinct concepts:* e.g., the Division 6 income of the trust estate versus the Division 6E income of the trust estate (and the analogues for present entitlement and net income);
- The fact that the 'Division 6E' concepts (Division 6E income of the trust estate, Division 6E present entitlement, Division 6E net income) *only* apply to the assessing provisions of Division 6, but not for other purposes and so for example, in the adjusted Division 6 percentage, present entitlement refers to whatever is income for trust purposes (including, potentially, capital gains);
- The fact that the adjusted Division 6 percentage, which is critical for calculation purposes is merely defined (in s95 ITAA36) by varying the Division 6 percentage, which is more fully stated (in s95 ITAA36)—but the Division 6 percentage, while it represents the judicially recognized proportionate approach, is not directly referred to in (other) legislative provisions, and apparently functions as a conceptual construct. The location of the adjusted Division 6 percentage in s95 ITAA36 is also inconvenient since it is used for calculation purposes in Subdivision 115-C ITAA97;
- In situations where the trustee is assessed in respect of a net capital gain—it is somewhat disorienting that Subdivision 115-C ITAA97 re-directs the trustee's assessment back to s99A (or

s99) ITAA36[78] or s98 ITAA36 (where it is a situation where the trustee must pay tax on behalf of a beneficiary), given that the general rule of the new scheme is that capital gains are stripped out of Division 6 and assessed under Subdivision 115-C ITAA97.

C *Suggestions and further comments (at a conceptual level)*

As discussed earlier in the paper, the *Bamford*-style proportionate approach cannot be reconciled with the streaming of particular classes of income for tax purposes. Philosophically, a scheme that enables streaming (as does that introduced by the 2011 amendments with respect to capital gains and franked distributions) recognizes that clear evidence of an intention to stream a particular class of income trumps the proportionate approach (at least as applied on a totals basis as per *Bamford*, pursuant to which a beneficiary's percentage of distributable trust income also equals their percentage share of trust taxable income). However, as discussed earlier, streaming can be given effect if it is recognised that the proportionate approach should be applied on a class of income basis (rather than a global basis) where the trustee has shown a clear intention to stream a particular class of income. Strategic reasons for streaming income arise if particular classes of income are associated with unique tax consequences, and so it is reasonable for the legislature to limit the range of income classes which can be streamed accordingly (principally, capital gains and franked distributions[79]).

If the trustee has not undertaken streaming, there is no need to bring such situations under a new regime, and indeed, as openly acknowledged by the Government, the use of the new provisions here produces the same results as under the old law pursuant to the proportionate approach.[80]

To the extent that streaming is not undertaken (i.e., the cases of partial specific entitlement), the amendments essentially adopts a proportionate approach (based on percentage present entitlements to trust income) to the division of the remaining part of the capital gain among beneficiaries. While this is an obvious default allocation, it is may be doubted whether the adjusted Division 6 formula is needed to achieve this. As shown above, in example A(iii), the same capital gain amounts can be arrived at using a different method, which may be more intuitive to some.

One area in need of definite correction pertains to the application of the legislation to situations of partial special entitlement where the trust deed does not include capital gains as part of trust income. As discussed above, a new anomaly is introduced insofar as beneficiaries' liability to tax is not in proportion to their economic entitlements. As outlined in Example B(iii), this problem can be resolved by allocating the capital gain (which is not the subject of specific entitlement) in accordance with the post-streaming distribution entitlements of the parties.

V Conclusion

As outlined in the paper, an ability to stream particular classes of income cannot be reconciled with the proportionate approach to the determination of a beneficiary's assessable income under s97

[78]As noted earlier, these provisions are relevant where there is trust income to which no beneficiary is presently entitled or the trustee has a specific entitlement amount pursuant to s115-230 ITAA97.
[79]As outlined by Boccabella (above n 1, 135), depending on the 'tax profile of beneficiaries,' there may also be strategic reasons to stream foreign source income and interest income (as differential tax treatment applies depending on whether the beneficiary is an Australian or foreign resident).
[80] EM 2.29.

ITAA36, which was confirmed by the High Court in *Bamford*. A legislative response was thus necessary given the widely accepted view that trustees ought to be able to strategically pass on the tax consequences of particular classes of income to beneficiaries. Insofar as capital gains are concerned (which were the focus of this paper), it is concluded that the streaming regime does substantially achieve its main purpose of enabling the tax effective allocation of capital gains among beneficiaries. However, that does not mean the regime is a success. In theory, the enabling of streaming *per se* would not appear to be a difficult legislative task. The legislation is too complex. This paper has tried to facilitate an understanding of the regime by showing how it applies to key scenarios where capital gains are included in trust income and when they are not, and within these categories, has considered situations without streaming, full streaming and partial streaming. A comparison with the pre-2011 position has been undertaken to show how the law has changed—favourable consequences were highlighted, as well as the creation of a new anomaly. In relation to the main problem of the complexity of the legislation, several distinct areas of potential confusion have been identified. It was also suggested that the basic philosophy of the regime can be given effect by adopting a proportionate approach on a 'class of income' basis.