



## WEEKLY COMMENT: WEDNESDAY 15 AUGUST 2012

1. This week I continue looking at the taxation of beneficiary income, with the focus on the Australian tax treatment of “net notional amounts” (the equivalent of deemed income derived by a trustee in New Zealand). As I noted last week, the ATO has issued a Draft Tax Ruling on this subject: TR 2012/D1 *Income tax: meaning of ‘income of the trust estate’ in Division 6 of Part III of the Income Tax Assessment Act 1936 and related provisions*.

### Taxation of beneficiary income in Australia

2. Some general information about the recent Australian trust taxation changes is available in a podcast transcript of *A CPA Australia interview with ATO senior tax counsel Fiona Dillon*. In Australia, work is progressing on a broad review and rewrite of the trust assessing provisions.
3. In Australia, a trust is seen as a mere conduit, and the taxation of the income derived by a trustee proceeds on the basis that it is apportioned to beneficiaries who are presently entitled to a share of the income of the trust estate. The beneficiaries are then taxed on their share. (Note, however, that trustees are taxed in relation to non-resident beneficiaries, including non-resident beneficiaries who are trustees of other (non-resident) trusts.)
4. Hence, the question of whether a distribution to a beneficiary is a gross or net amount does not arise. Each beneficiary is taxed as follows:
  - (a) First, all beneficiaries who are presently entitled to a share of the trust’s income are identified.
  - (b) Second, each beneficiary’s proportional entitlement to the income of the trust estate (which is the distributable income of the trust based on trust principles) is established.
  - (c) Third, the net income of the trust for tax purposes is apportioned to each beneficiary based on their proportional entitlement to the trust’s distributable income.

### Beneficiaries who are presently entitled

5. The scheme of Australian tax legislation applying to trusts was recently reviewed by the High Court of Australia in *Commissioner of Taxation v Bamford; Bamford v Commissioner of Taxation* [2010] HCA:

“39. Further, the phrase “presently entitled to a share of the income” directs attention to the processes in trust administration by which the share is identified and entitlement established. The relevant operation of those principles, supported by a review of the authorities, was described as follows by Bowen CJ, Deane and Fitzgerald JJ in *Federal*

*Commissioner of Taxation v Totledge Pty Ltd* [1982] FCA 64, (1982) 40 ALR 385 at 393. Their Honours said:

A beneficiary under a trust who is entitled to income will ordinarily only be entitled to receive actual payment of the *appropriate share of surplus or distributable income*: the trustee will be entitled and obliged to meet revenue outgoings from income before distributing to a life tenant or other beneficiary entitled to income. Indeed, circumstances may well exist in which a trustee is entitled and obliged to devote the whole of gross income in paying revenue expenses with the consequence that the beneficiary entitled to income may have no entitlement to receive any payment at all. This does not, however, mean that a life tenant or other beneficiary entitled to income in a trust estate has no beneficial interest in the gross income as it is derived. He is entitled to receive an account of it from the trustee and to be paid his share of what remains of it after payment of, or provision for, the trustee's proper costs, expenses and outgoings." (emphasis added)

### **Income of the trust estate**

6. The phrase "income of the trust estate was explained as follows by Sundberg J in *Zeta Force Pty Ltd v Commissioner of Taxation* [1998] FCA 728, (1998) 84 FCR 70 at 74-75:

"The words 'income of the trust estate' in the opening part of s 97(1) refer to distributable income, that is to say income ascertained by the trustee according to appropriate accounting principles and the trust instrument. That the words have this meaning is confirmed by the use elsewhere in Div 6 of the contrasting expression 'net income of the trust estate'. The beneficiary's 'share' is his share of the distributable income."

7. It follows from the quote from *Totledge* above that "income of the trust estate" is a *net concept*. This is noted in TR 2012/D1:

"100. This was confirmed by the Full Federal Court in *Cajkusic v Commissioner of Taxation* [2006] FCAFC 164; 2006 ATC 4752; (2006) 64 ATR 676, observing at [27]:

" this case is concerned with the proper determination of the net distributable income - the s 97 income.

101. Accordingly, as the income of the trust estate for an income year for section 97 purposes is a net concept that, as explained in paragraph 89 of this draft Ruling, has to represent *an accretion* to the trust estate for the relevant income year, it cannot in total exceed:

- the accretions to the trust estate (whether accretions of property, including cash, or accretions of value) for that year;
- *less* any accretions to the trust estate for that year which have not been allocated, by the deed or by the trustee acting in accordance with a power granted under the deed, to income (and therefore cannot be distributed as income); and
- *less* any depletions to the trust estate (whether depletions of property, including cash or value) for that year which the deed, or the trustee acting in accordance with a power granted under the deed, has allocated as being chargeable against income."

(emphasis added)

## Net income of the trust estate

8. It was noted in *Bamford* that the phrase "the net income of the trust estate" is to be read with the definition in s 95(1):

"**net income**, in relation to a trust estate, means the total assessable income of the trust estate calculated under this Act as if the trustee were a taxpayer in respect of that income and were a resident, less all allowable deductions, except deductions under Division 16C or Schedule 2G and except also, in respect of any beneficiary who has no beneficial interest in the corpus of the trust estate, or in respect of any life tenant, the deductions allowable under Division 36 of the *Income Tax Assessment Act 1936* in respect of such of the tax losses of previous years as are required to be met out of corpus."

## Example showing how beneficiary income is taxed in Australia

9. Example 2 in TR 2012/D1 explains how this works:

For the purposes of the Brisbane Family Trust deed 'income' is defined to mean the net income of the Fund in any Financial Year determined in accordance with subsection 95(1) (of the *Income Tax Assessment Act 1936*).

For the 2009-10 income year, the trust's net income as defined in s. 95 is \$100,000, made up of a franked dividend of \$70,000 and franking credit of \$30,000. The trustee has no other relevant income or expenses for that income year.

The trustee resolves to distribute the trust income to resident beneficiaries as follows:

- Amy Brisbane: \$416;
- Barry Brisbane: \$416;
- Charitable Brisbane Inc.: \$20,000; and
- Deal Brisbane Pty Ltd: The remainder.

Despite the terms of the deed, the \$30,000 franking credit does not represent an accretion to the trust fund and therefore does not form part of the distributable income of the trust. The trust's distributable income is \$70,000.

Applying the proportionate approach, each beneficiary's share of the trust's distributable income and their corresponding proportionate share of the trust's net income, is as calculated below:

### Beneficiary's share of income of the trust estate (i.e. trust income)

- Amy Brisbane: Share of distributable income =  $(\$416/\$70,000) = 0.59\%$ .
- Barry Brisbane: Share of distributable income =  $(\$416/\$70,000) = 0.59\%$ .
- Charitable Brisbane: Share of distributable income =  $(\$20,000/\$70,000) = 28.57\%$ .
- Deal Brisbane: Share of distributable income =  $(\$49,168/\$70,000) = 70.25\%$ .

### Beneficiary's share of net income of the trust estate (i.e. taxable income)

- Amy Brisbane: Share of net income =  $0.59\% \times \$100,000 = \$594$ .
- Barry Brisbane: Share of net income =  $0.59\% \times \$100,000 = \$594$ .
- Charitable Brisbane: Share of net income =  $28.57\% \times \$100,000 = \$28,571$ .
- Deal Brisbane: Share of net income =  $70.25\% \times \$100,000 = \$70,240$ .

## **Importance of trust law principles**

10. It can be seen from the foregoing discussion that beneficiary income in Australia – i.e. income that is taxed to each beneficiary – depends on their share of distributable income determined under trust law principles. Therefore, the terms of a trust deed are extremely important for Australian tax purposes as well.
11. In the *podcast* referred to earlier, Fiona Dillon stated:
- “... income of the trust is a concept founded in the general law of trusts. So there is no set meaning - the income of any particular trust will generally depend on the terms of the trust deed and the actions that the trustee has taken pursuant to it. So one thing we keep stressing both to our staff in the context of audits, litigation and private rulings that involve trusts and when speaking to practitioners about trusts is that the trust deed, and any other document evidencing actions or decisions of the trustee (such as relevant resolutions and the trust accounts) must be carefully considered before the income of the trust estate for trust purposes can be determined.”
12. This gives rise to the same problem in Australia regarding the distribution of deemed income – referred to there as “net notional amounts” – to beneficiaries. In the *podcast*, Fiona Dillon stated that:
- “One of the main reasons for issuing the ruling was to explain the Commissioner's view that net notional amounts cannot generally form part of this income of a trust estate...
- Many trust deeds equate the trust's income for trust purposes with its taxable income. However taxable income may include amounts that have not actually come home to the trust, other than for tax purposes - franking credits are a typical example but there are others.
- For example, if a trustee disposes of an asset for less than its worth, the capital gain recognised for tax purposes will be greater than the actual gain realised by the trust due to the market value substitution rule. The additional amount taxed does not represent any real value that has come into the trust that a beneficiary could be made presently entitled to and demand payment of. Accordingly we say that these net notional amounts are not capable of forming part of the income of the trust estate for our purposes.
- If we instead took the view that these amounts were income of the trust estate, then because they would still not be amounts that had come into the trust to which a beneficiary could be made presently entitled, it would be income that was not capable of distribution. This would mean that some part of the trust's taxable income would be assessed to the trustee.”
13. In Australia, as noted earlier, the trustee is not assessed on any of the trust's taxable income. Therefore, in Australia, “deemed income” is excluded from the total distributable income of a trust when calculating a beneficiary's share of the distributable income. In that way, the entire taxable income of the trust is able to be proportionately assessed to the beneficiaries.

## **Example showing the taxation of deemed income to a beneficiary**

14. Example 3 in TR 2012/D1 shows how “net notional amounts” are taxed to a beneficiary:

The Melbourne Family Trust deed does not define income. Therefore, its distributable income will be calculated having regard to the rules and presumptions in general trust law.

Without more, these rules would operate to exclude capital gains from the distributable income.

During the 2009-10 income year the trustee derived \$5,000 interest income and made a \$2,500 (non-discount) capital gain. Accordingly for that year the distributable income of the trust estate is \$5,000 but its net income (i.e. taxable income) as defined in subsection 95(1) is \$7,500.

The beneficiary presently entitled to the whole of the income of the Melbourne Family Trust is Sydney Co in its capacity as trustee of the Sydney Family Trust. The trustee of the Sydney Family Trust includes in its assessable income under section 97 the whole of the net income (i.e. taxable income) of the Melbourne Family Trust, namely \$7,500 (even though its actual entitlement is limited to \$5,000 – the distributable income of the Melbourne Family Trust). The beneficiary is therefore taxed on the entire taxable income of the Melbourne Family trust, including the capital gain.

The deed of the Sydney Family Trust defines 'income' as equal to the trust's s. 95 net income (i.e. the Sydney Trust defines its trust income as its taxable income). However, on these facts, the Sydney Family Trust's distributable income is limited to the \$5,000 to which it was entitled from the Melbourne Family Trust. The \$2,500 'notional amount' that is included in the assessable income of the Sydney Family Trust, but which is not represented by an accretion to the trust fund, does not form part of its distributable income.

Assume that on or before 30 June 2010 the trustee of the Sydney Family Trust distributes the \$5,000 it was entitled to receive from the Melbourne Family Trust to its beneficiary, Canberra Company. Although \$5,000 is only 66.7 per cent of the income as defined under the Sydney Family Trust's deed, it represents 100 per cent of the 'income of the trust estate' for Division 6 purposes. Accordingly, Canberra Company – the beneficiary - will be assessed under s. 97 on the full \$7,500 net income (i.e. taxable income) of the Sydney Family Trust, and no amount will be assessed to the trustee of the Sydney Family Trust.

### **Conclusion and comparison between New Zealand and Australia**

15. The fundamental difference between the New Zealand and Australian tax regimes is that trustees are not taxed in Australia, except in relation to non-resident beneficiaries. (A non-resident trustee that is a beneficiary of an Australian trust is taxed as a beneficiary, not as a trustee.)
16. In Australia, the net taxable income of a trust is apportioned to beneficiaries based on the share they are presently entitled to of the trust's distributable income. Under principles of trust law, they are not presently entitled to "net notional amounts" – the equivalent of "deemed income" in New Zealand. To the extent that such amounts are included in a trust's distributable income, there will be no beneficiaries presently entitled, and so a portion of the trust's taxable income cannot be apportioned to beneficiaries. The ATO's solution – and the main issue in Australia in relation to deemed income - is to exclude net notional amounts from a trust's distributable income when determining a beneficiary's share.
17. In Australia, it is not possible to distribute a trust's gross income to beneficiaries and there is no distinction between gross and net income in Australia. The "income of the trust estate" is a net distributable amount, and the "net income of the trust estate" is the net taxable amount.

18. In New Zealand, IS 12/02 allows deemed income to be taxed as beneficiary income when the terms of a trust deed permit such income to be distributed as beneficiary income. IS 12/02 implies that beneficiary income will be net income of the trustee. However, the *Income Tax Act 2007* permits gross income derived by a trustee to be distributed as beneficiary income. The main issue in New Zealand in relation to deemed income is to draft the income distribution terms of a trust deed to ensure that the desired tax results can be obtained in respect of beneficiary income.



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