



Ms Kate Roff
The Chair
NTLG
Trusts Consultation Working Group
The Treasury

Via Email

9 October 2008

Dear Ms Roff,

RESPONSE TO: DISCUSSION PAPER RELATING TO TRUST INCOME, SHARE, DISTRIBUTABLE INCOME AND RELATED MATTERS

Taxpayers Australia are pleased to provide comment to Treasury in response to the Trust Consultation Sub-Group Discussion Paper issued 19 June 2008, concerning a number of issues central to the operation of Division 6 and in particular the following:

- the meaning of the term 'income of the trust estate' in subsection 97(1)
- the meaning of the term 'share' in that provision, and
- the relevance of, and measurement of, distributable net income of the trust in determining present entitlement of beneficiaries.

The appended document sets out our views in response to the issues raised.

We take this opportunity to commend the Tax Office's initiative to provide interim clarity by way of the *Cajkusic* Decision Impact Statement (DIS). While in the most the *Cajkusic* DIS provides positive outcomes, we are not fully in accord with the Commissioner of Taxation's views and await the judicial outcome of the appeal in *Bamford*.

Should you wish to discuss any aspect of this response paper, please contact either Heather Schache or Jacqueline Hodges on 1300 657 572.

Kind regards

Heather Schache
General Manager Taxation and Superannuation Publications



Trust income, share, distributable income and related matters

Overview

Taxpayers Australia appreciates the difficulties surrounding the meaning of the terms 'income of a trust estate' and 'share' in relation to the distributable net income.

These terms remain insufficiently clear and require further clarity. We look forward to the judicial clarification from the appeal in the *Bamford* case.

However, putting aside specific instances of 'sham' transactions, trustees must resolve to distribute a share of net income in accordance with the current interpretation of law.

We hold the view that to penalise taxpayers for applying what would be considered the accepted practice in distributing that share of the net income should the appeal result in a different approach would be an injustice.

Our preferred option would be that taxpayer's:

- be allowed to distribute that share of net income as a consequence of what is considered a current interpretation of the law for the intervening period, and
- be made aware of changes, if any, to the interpretation and operation of the law surrounding trust income.

This approach would provide trustees with certainty that they had acted in a fit and proper manner with regard to resolving the trust income and the distribution of a share of such income as a consequence of the prevailing interpretation of law.

Furthermore, going forward if changes to the interpretation of trust income arise, trustees will have opportunity to adopt any such change when resolving the income of the trust and the distributions thereto.

Income of the trust estate in section 97

Taxpayers Australia agrees that the income of the trust estate may not always equate to the distributable net income of the trust and may be defined under the terms of the trust deed.

While income of the trust may be affected by definitions of income under the deed or the express or implied powers given to the trustees, these definitions do not arise as a chance interpretation or device by our constitutional lawyers. Rather, these definitions typically are derived from previous legal interpretation stemming from the Courts. In our opinion,

Office:
1405 Burke Road
Kew East
Victoria 3102

Telephone: (03) 8851 4555
Fax: (03) 9819 7720
email: info@taxpayer.com.au
Web: www.taxpayer.com.au

Post Office Box No.
PO Box 292
Kew East
Victoria 3102



trustees are not apt to interpret the character of income without regard to statute or judicial interpretation.

We accept that the net distributable income resolved by the trustee, after considering the terms of the trust deed and Generally Accepted Accounting Principles (GAAP), is that calculated as being available for distribution to the beneficiaries. With this in mind it is necessary that the Tax Office consider each trust on its on merit and in the context of each respective deed.

We are not completely satisfied with the Tax Office view offered in the *Cajkusic* DIS. This view would seem incongruent with that of the Full Federal Court, which indicated that the income of the trust may be defined by the trust deed for the purposes of s97.

Is income of the trust estate a gross or a net concept?

Taxpayers Australia agrees with the Tax Office view that the income of the trust estate under trust law generally refers to the gross income received by the trust according to accounting concepts and under the terms of the trust deed.

We are aware that certain deeds have adopted clauses to align the income of the trust under s97 to the net income of a trust as determined under s95. Accordingly, our understanding is that trustees have ascertained trust income to be a net concept.

We await the outcome of *Bamford* to clarify the meaning of income of a trust estate under s97.

What appears omitted from the discussion is the concept of trust profit being the net of trust income after expenses and revenue losses. If the terms of the trust deed are found to set out what is the income of the trust, then some consideration must be given to this concept in the future.

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Kew East
Victoria 3102



What is the meaning of 'share', and how does present entitlement work, if income of the trust estate is ordinary income (usually a gross amount)?

Taxpayers Australia appreciates the meaning of share typically from a trust law perspective refers to a share of the gross amount.

Yet, as we perceive this must be considered from a taxation view then the question as indicated above must await the outcome of *Bamford*.

Present entitlement and distributable net income

Taxpayers Australia accepts the Tax Office view that trustees may adopt either the proportionate or quantum approach. We acknowledge the use of one approach over the other for the avoidance of tax may attract Tax Office concern and investigation into the arrangement.

That said, we affirm the importance that where available that trustees retain the discretion to apply the approach that provides the most satisfactory outcome rather than disadvantage or penalise a beneficiary where trust income does not equate to the taxable distribution.

Must a payment or provision be authorised by the deed or relevant legislation for offset against income?

Taxpayers Australia believes it is an unnecessary complication that payment or provision must be authorised by the deed of legislation but acknowledges that there are deeds with clauses authorising such a payment or provision. Contemporaneous case law exists to assist trustees in determining whether a payment or provision may be offset against income, for example: proceeds from disposals outside of the ordinary course of business; *Re Bowman*. Further, in lieu of such guidance it is considered reasonable that trustees apply GAAP and accounting standards.

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If an amount is paid or expensed in breach of trust would it effectively be treated as if it had not been so paid or expended?

Whilst it would appear for the preceding paragraphs that this clause is intended to refer to payments made during the course of business, it is unclear as to whether the query in fact refers only to payments made by the trustee during the course of business or if reference is also made to a beneficiary who is not presently entitled. For the avoidance of confusion, Taxpayers Australia chooses not to comment on this item.

Does deed authorisation include a situation where an item is defined in relation to something else or where a trustee has discretion to treat a particular amount in a particular way in determining what can be offset against income?

Taxpayers Australia agrees that deed authorisation would include situations where the deed includes specific clauses for either:

- equating trust income to s95 net income thereby reporting taxable income,
- or
- providing express or implied discretionary powers to the trustee.

Must a provision relate to an existing liability or obligation, even though its timing and/or amount may not be known? That is, it must be an expense or an outgoing, rather than an accumulation or a reserve for future expenditure.

Taxpayers Australia agrees that a provision must relate to an existing liability as per AASB137, but makes note that an amount would only be provided for, where there is a probable and quantifiable economic outflow of resources. Where the outflow is uncertain no provision would be made.

If provisions or reserves of amounts which did not represent a reduction in distributable funds or close estimate thereof could be subtracted from income in determining the distributable net income, can the policy of section 99/99A be readily defeated?

This item returns to the question what is the income of a trust. If income can be determined by the trustee under the governing powers of the deed, then it may be considered that the section could be readily defeated.

However, it would seem that this item considers the nature of distributable net income in isolation of other taxing provisions. Future liabilities of the nature of provisions or reserves do not necessarily defeat section 99/99A.

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Whilst, *prima facie*, it may appear that a provision included in the calculation of distributable net income, would represent a deferral of distributable income to those beneficiaries. However, this would not necessarily defer the taxing point for those presently entitled. In fact it would seem more likely that these amounts would become deductible for tax purposes against trust income in future years.

For example, should a provision for long service leave accrued reduce the net distributable trust income, a net movement in the provision would be reflected in the tax reconciliation. This would be taxed in the current year, either in the hands of the beneficiaries presently entitled or taxed to the trustee.

For this reason, we do not believe that the provisioning of amounts could readily defeat section 99/99A.

By way of example, if a trust had \$100,000 gross income, \$80,000 current expenses, and a provision for possible future expenses of \$10,000, beneficiaries would have to be presently entitled to \$20,000 in order to prevent s99/s99A from applying.

We agree, given the general application of reconciling those items which are not deductible in the current year. Also, noted and agreed is that section 99/99A would not apply if there exist, beneficiaries presently entitled to a share of the net income of the trust.

Can the expense be something that is not deductible for tax purposes, for example entertaining expense? Is there then a basis for limiting permissible trust expenses to amounts that are deductible for tax?

It would be incongruent to limit permissible trust expenses to only those that are deductible for tax purposes. Given the example of entertainment expenses whether these amounts are deductible is irrelevant, if they are genuine expenses of trade. The trustee by including these amounts would be correctly recording the costs associated with the business.

Taxpayers Australia agrees that there is no basis for limiting permissible trust expenses to those that are deductible. These are a consideration of trust law in determining trust income and do not extend whether the amounts represent taxable income of the trust.

If the deed permits, may an expense be capital rather than revenue?

Taxpayers Australia appreciates that the trust deed may direct the trustee in the treatment

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of an expense, but refrain from making comment on this issue.

Can the trust deed override accounting principles or standards in determining what expenses are properly offset against income?

Yes, the trust deed is the initial source for assisting the Trustees in determining the trust income. However, should the trust deed be silent then GAAP or accounting standards apply.

Note, while the trust deed may empower the trustees with the ability to determine those expenses that may be properly offset against income less emphasis will apply to the accounting standards where the trust is not a reporting entity, although generally accepted accounting principles will still apply. However, where the trust is a reporting entity, a dilemma will arise if the deed is not consistent with accounting standards or GAAP.

If, for accounting purposes, prior year losses are offset in determining the retained earnings balance, are there circumstances where this should be taken to signal a case where the losses have been taken against capital rather than against future income?

Taxpayers Australia, acknowledges the difficulty arising in respect of prior year and also current year losses whether that loss be of a revenue or a capital nature. However, we observe that 'retained earnings' is not typically an account noted in the balance sheet of a trust entity.

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