

Taxation

On 2 June 2010, the Commissioner of Taxation (Commissioner) released his *Decision Impact Statement* on the High Court decision of *Federal Commissioner of Taxation v Bamford* [2010] HCA 10 (Bamford) and *Practice Statement* PS LA 2010/1 (Statement).

This bulletin examines the implications of Bamford and the *Decision Impact Statement*, and how this affects your trusts in the 2010 income year and beyond.

What must I do before 30 June 2010?

The most important message arising out of Bamford and the *Decision Impact Statement* is to read your trust deed carefully. With this in mind, we raise the following points:

- a review of your trust deed should be well underway by now, with a particular focus on your trust's definition of 'income'. If no such definition exists, you should consider amending the trust deed to insert an appropriate definition of 'income'. You should also consider the insertion of an income re-characterisation clause, if one does not already exist. All recent Arnold Bloch Leibler trust deeds should have an appropriate definition of 'income' and, if your Arnold Bloch Leibler deed was settled within the last 20 years, it should also have an appropriate income re-characterisation clause; and
- although a lot of attention has been focused on trusts in the last few months, there should be no need for alarm. In regard to the making of trust distributions, this income year is largely 'business as usual'. Perhaps most importantly, you can still apply the capital beneficiary approach set out in *Practice Statement* PS LA 2005/1 (GA) (CGT Statement), in this income year (however see our comments below). Nevertheless, the CGT Statement, along with other rulings, will be withdrawn from 1 July 2010. This will raise significant issues that will need to be resolved in the 2011 income year, regardless of what your trust deed says. We will keep you informed of developments in this area.

Arnold Bloch Leibler appreciates that this detailed analysis of the implications of Bamford is particularly technical. For further details and assistance, please forward this bulletin to your accountant or contact Arnold Bloch Leibler's tax department for further advice.

What is Bamford all about?

Under section 97 of the *Income Tax Assessment Act 1936*, a beneficiary who is presently entitled to a share of the 'income of the trust estate', is assessed on 'that share' of the trust's [tax] net income.

In Bamford, the High Court confirmed that:

- the meaning of trust law income is derived from general trust law concepts and may be changed by the trust deed (the Income Issue); and
- a beneficiary of a trust is taxed on the same proportion of [tax] net income as the proportion of trust law income to which the beneficiary is presently entitled (the Proportion Issue).

Bamford did not turn out to be the ground-breaking trusts decision that some were anticipating. The decision of the High Court was largely consistent with our understanding (and application) of the taxation of trusts. We always thought that primacy should be given to the terms of the trust deed (i.e., that 'income' should mean whatever the trust deed says it is). Further, the proportionate approach has, for the most part, generally been accepted as the correct approach for the taxation of the [tax] net income, which Bamford confirmed. The Commissioner, however, appears to be far from satisfied with Bamford, and suggests in the *Decision Impact Statement* that Bamford only provides guidance for cases that are precisely on point with respect to the decision.

What has the Commissioner said in the *Decision Impact Statement*?

The Income Issue

In relation to the Income Issue, the Commissioner has taken a narrow approach to Bamford by seeking to limit the way in which a trustee can determine distributable trust income. We raise the following points:

- the starting point is that 'income of the trust estate' takes its meaning from the general law of trusts and not from taxation law;
- the Commissioner accepts that the concept of 'income' under trust law can be displaced by express provision in the trust deed. In our view, given that the meaning of 'income' under general trust law concepts is complex, it is advisable for a trust deed to have an 'income' clause that provides the trustee with a degree of flexibility. Most modern trust deeds (including Arnold Bloch Leibler trust deeds) should have such a clause;
- the Commissioner accepts that income re-characterisation clauses can be effective to treat a capital amount as 'income of the trust estate'. Similarly, a trust deed may determine whether an outgoing is properly chargeable against the income of a period. However, the Commissioner does not appear to accept that a re-characterisation clause can operate in reverse by treating income as capital. If you have an Arnold Bloch Leibler trust deed, which has been settled within the last 20 years, it should already have an appropriate income re-characterisation clause;

- it remains unclear whether non-existent amounts (for example, deemed capital gains as a result of the market value substitution rule and amounts included in assessable income under Part IVA) can effectively be treated as ‘income’ under the trust deed. Although the *Draft Decision Impact Statement* clearly stated that distributable amounts can only be based on actual increments to the trust fund, the Commissioner appears to have reserved his decision on this issue. This issue raises particular problems for ‘income equalisation clauses’, which seek to equate ‘income’ with the trust’s [tax] net income; and
- the Commissioner notes that taxpayers may wish to amend their trust deeds to insert a definition of income where one does not exist and, in particular, insert an income re-characterisation clause or income equalisation clause. In our view, it is unlikely that such variations (validly made) will amount to a creation of a new trust and give rise to CGT events. However, the facts and circumstances of each trust must always be considered.

The Proportion Issue

The High Court in Bamford endorsed the proportionate approach to the determination of a beneficiary’s assessable income. That is, after ascertaining a beneficiary’s share of distributable income, the beneficiary is assessed on that proportion of the whole of the [tax] net income. We raise the following points:

- in relation to the Proportion Issue, the Commissioner has read into the Bamford decision a finding that subject to the possible operation of provisions outside Division 6 the amount included in a beneficiary’s assessable income under section 97 consist of an ‘undissected or un-allocated proportionate share of the entirety of the [tax] net income’. This statement is a strong indication that the Commissioner no longer accepts that a trustee can effectively stream different types of income and capital gains to different beneficiaries; and
- the Commissioner’s interpretation of Bamford means that a number of rulings will be withdrawn from 1 July 2010. Among those rulings is the CGT Statement that, in the past, has provided taxpayers with practical administrative concessions for the purpose of taxing capital gains of trusts. However, taxpayers are able to self-assess in accordance with the CGT Statement (and other similar rulings) for the year ending 30 June 2010. A word of caution: just because a taxpayer can self-assess in accordance with the CGT Statement does not mean that the Commissioner will accept the taxpayer’s position in an audit context. In the Statement (discussed below), the Commissioner specifically states that despite the fact that taxpayers can self-assess in accordance with the CGT Statement in the 2010 and earlier income years, Tax Office staff must apply the Commissioner’s view of the law (presumably, post-Bamford and in accordance with the *Decision Impact Statement*) if the assessment of the [tax] net income arises in a dispute. The CGT Statement may provide a reasonable basis for settling a dispute with taxpayers in respect of the 2010 and earlier income years. Further, reliance on the CGT Statement is likely to shelter taxpayers from the imposition of administrative penalties.

What has the Commissioner said in the Statement?

In respect of the 2010 and earlier income years, the Commissioner will not be selecting cases for active compliance to correct errors in the way in which taxpayers have lodged tax returns or administered their trusts on the basis of views inconsistent with the Commissioner’s view of Bamford. However, if there is a dispute for some other reason (for example, because there is a dispute about the quantum of the trust’s [tax] net income), and adjustments are to be made, the adjustments will be made on the basis of the law as explained in Bamford.

The Commissioner has advised Tax Office staff to be alert to, and to continue to identify, arrangements in respect of any income year that seek to avoid some or all of the liability in respect of the [tax] net income of a trust.

For the 2010 and earlier income years, the Commissioner will accept that taxpayers have taken ‘reasonable care’ and that their position is ‘reasonably arguable’ (which means that no administrative penalties are imposed by the legislation) where taxpayers have prepared returns on the basis of the Commissioner’s views in Bamford or on the basis of an alternative view that is reasonably open having regard to other relevant authorities.

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