

# Taxation of trust income 'post Bamford': Important legislative changes impending

*Associate, Will Fennell reviews draft exposure legislation expected to affect the taxing of trust income for the 2010 -11 income year.*

On 13 April 2011 the Assistant Treasurer released exposure draft legislation, which when passed will effect the taxing of trust income in the 2010 - 11 and later income years.

The amendments are a consequence of the 2009 decision of the High Court in the Bamford litigation. The effect of that decision is that in determining a beneficiary's taxable income, the following two step process is required:

- First, a beneficiary's present entitlement to the distributable income of the trust estate is worked out according to principles of trust law, and
- second, once that percentage share of distributable income is determined, that percentage is applied to the [tax] net income of the trust, ie under the principles of tax law.

For trust deeds where the definition of income is not aligned with the definition of income under the relevant tax laws, the resulting mismatch can result in unfairness, as a beneficiary's income for tax law purposes can be at odds with the actual sum distributed to the beneficiary by the trustee pursuant to trust law.

In this context, the Government has proposed legislation that, where allowed by the trust deed, will enable the streaming of franked distributions and capital gains. Importantly, the amendments will introduce the concept of 'specific entitlement' to ensure that a taxpayer's 'share' of any capital gains and franked distributions equate to their entitlement under the relevant trust deed. Further, an anti-avoidance measure applying to certain income tax exempt beneficiaries will be included.

Whilst all practitioners whose clients are trustees need to be aware of the changes, the draft legislation has particular relevance for practitioners with trustee clients who have capital gains or franked distributions available for distribution for the 2010/11 financial year.

## [Streaming of franking credits and capital gains](#)

Whilst this note does not set out the steps required to make the relevant calculations, in broad terms, the intended outcome of the provisions for the streaming of capital gains and franked distributions will be as follows:

- Capital gains made and franked distributions derived by a trustee to which beneficiaries are specifically entitled will be 'streamed' on a **quantum** basis to those beneficiaries, along with their tax attributes (such as franking credits);
- Such amounts to which no beneficiary is specifically entitled will flow **proportionally** to beneficiaries based on their share of the 'income of the trust estate' (net of amounts to which a beneficiary is specifically entitled), or to the trustee if there is a part of the 'income of the trust estate' to which no beneficiary is presently entitled.

The calculations required to be made pursuant to the draft legislation will in some circumstances be complex. This is particularly so where the trustee will be distributing both capital gains and franked distributions.



### Anti-avoidance

The specific anti-avoidance rule will prevent the use of low tax entities (for example tax exempt bodies) sheltering the taxable income of a trust. The rule will apply where a low tax entity would otherwise be assessed on a disproportionate share of a trust's net income, relative to their actual entitlements to the net taxable accretions to the trust (whether 'income' or 'capital').

### Practice points

If the proposed amendments are enacted by 30 June 2011, it is expected that the provisions will not allow trustees to amend trustee resolutions made on or before 30 June 2011.

Accordingly, practitioners whose trustee clients have capital gains or franked distributions available for the 2010/11 year should advise those clients to defer making their annual trustee resolutions regarding the distribution of income until the revised legislation has come into effect.\*

In any event, the relevant trust deeds should be reviewed now to determine if (once enacted), the streaming provisions will apply. Obviously, care will need to be taken to avoid a resettlement of the trust if a deed is sought to be amended.

A further Tax Alert will be issued when the final draft of the legislation is released.

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*\* It is expected that the amendments will be passed prior to 30 June 2011. For the avoidance of doubt, if the amendments are not passed by that time, trustees must still adhere to their existing obligation to pay or apply income for the benefit of a beneficiary before the end of the income year in order to avoid the trustee being taxed on the income of the trust.*