

Tax Law Case Note

9 April 2010

Landmark Tax Decision on Trusts – Bamford v The Commissioner of Taxation

by Peter Gell, Partner

Does this decision provide clarification on the taxation of trusts?

The much awaited decision of *Bamford v The Commissioner of Taxation* was delivered by the High Court on 30 March 2001.

Members of the tax profession have been awaiting the decision in the hope that it might give some definitive clarification on the taxation of trusts, particularly where there is a difference between income of the trust calculated on a trust law or accounting basis, and income calculated on a taxation basis.

The High Court judgement contains an interesting summary on the distinction between the calculation of income on a trust law basis and the calculation of income on a taxation basis.

The calculation of the income on a trust law basis is determined by what the trust deed says. The trust deed can, for example, reclassify receipts into the trust and distributions out of the trust. Receipts of income can be reclassified as receipts of capital and vice versa – the same with distributions. The terms of the trust deed are of primary importance in that regard. The trust deed may also give a discretion or power to the trustee to allocate expenses against either income or capital.

Case Facts

The case concerned appeals both the Commissioner and the taxpayer on the approach to be taken where there were

differences between tax income and trust income. This is now the leading decision on the interpretation of s97 *Income Tax Assessment Act 1936*.

This section provides, in substance, that where a beneficiary is “presently entitled” to a “share” of the “income” of a trust estate his “assessable income” shall include “that share” of the “net income” of the trust estate.

In analysing these terms and their meaning, the High Court followed the decision of the Full Federal Court and dismissed the appeals of both the Commissioner and the taxpayer.

The Commissioner’s appeal concerned the inclusion of a net capital gain into the trust law income – that is the trustee treated that net capital gain as “income of the trust estate” for the purposes of the determination of present entitlement.

Capital gain is not normally income according to ordinary concepts. The trustee decided to include the capital gain as income for determining the persons and entities to whom it was to be distributed. The trustee could do this under the terms of the trust deed.

The Commissioner contended that the trustee was to be assessed on the basis that there was no income of the trust estate under normal trust law principles to which any beneficiary was “presently entitled,” leaving the trustee to be assessed under s 99A of the *Income Tax Assessment Act 1936*.

Not so, said the High Court. The trustee had treated the gain as income under the terms of the trust and as there were beneficiaries presently entitled to that income, the taxation on the gain fell on those beneficiaries at normal adult marginal rates and not on the trustee at the penal rate of tax under s99A.

In other words the word “share” in section 97 was a reference to income determined under the terms of the trust deed – it is trust income – and once a “share” is determined in relation to that income, the same “share” is then applied in determining the tax liability to the “net income” which is the net income of the trust estate calculated under the terms of s95 *Income Tax Assessment Act 1936*.

The Appeal – disallowance of a deduction for tax purposes

The taxpayer’s appeal concerned the disallowance of a deduction for taxation purposes. This disallowed deduction was then added to the net income of the trust estate and the Court had to determine the tax liability on the additional tax income.

The resolutions by the trustee had allocated defined sums to beneficiaries with the remainder to the Church of Scientology.

The High Court determined that the liability to tax to the additional tax income was determined in accordance with the ratio that the actual distributions made, pursuant to the trustee resolutions, to each beneficiary

on a trust income basis, bore to the total distributed trust income.

That same percentage (called "portion" as distinct from a "part") was then applied to the increased tax income to work out the tax liability among the beneficiaries who were presently entitled to the trust income. This is adopting what is called the "proportionate" approach in the taxation of the income of the trust estate. The Court quoted with approval this approach which was initially articulated by Sundberg J in the case of *Zeta Force Pty Limited v Commissioner of Taxation* (1998) 84 FCR at 70.

The end result was the correctness of an assessment made by the Commissioner to the taxpayers of this additional tax income using this proportionate approach. Ironically, the taxpayer had argued, in this aspect of the case, that the additional taxation income occasioned by the disallowance of the deduction should be payable by the trustee.

What is the impact of the decision?

Well, if the terms of the trust are important in determining income on a trust law basis, It is important that trust deeds contain alternative bases in the calculation of the income of the trust estate – they must allow the trustee to choose income for distribution either on a trust law basis, accounting basis or taxation basis – depending on which outcome is sought to be achieved.

Generally speaking the objective is to ensure that income is not imposed on the trustee at penal rates of tax under s99A *Income Tax Assessment Act*. It is therefore important to ground a present entitlement to a beneficiary to ensure that the income of the trust is taxed at normal adult rates. In some circumstances, it may be preferable to achieve the opposite result – that is, to have no beneficiary presently entitled to the income of the trust (on a trust law basis) thereby attracting tax to the trustee.

Modern trust deeds now give considerable flexibilities to the trustee in determining the basis of the calculation of the income of the trust estate, the ability to allocate expenses and (in addition) a choice as to how to recoup losses – from either capital or from current year profits. These powers enable maximum flexibility in determining what the trust law income is, who is entitled to it and where the taxation incidence lies.

Conclusion

It is worthwhile considering whether the terms of any family discretionary trust you or your clients may have, contain flexibilities in terms of the choice of calculation of the income of the trust and the ability to reclassify receipts in and distributions out of the trust. If the trust does not contains these types of provisions then some consideration should be given to amending its terms. Any amendment needs to be done with some care in order to avoid a resettlement of the trust. Please contact us for help or assistance.

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