

Extract EM – Tax Law Bill 5 2011

Interim changes to improve the taxation of trust income

- **Outline of chapter**

2.1 Schedule 2 to this Bill amends Subdivision 115-C and Subdivision 207-B of the *Income Tax Assessment Act 1997* (ITAA 1997) to ensure that, where permitted by the trust, the capital gains and franked distributions (including any attached franking credits) of a trust can be effectively streamed for tax purposes to beneficiaries by making them ‘specifically entitled’ to those amounts.

2.2 These amendments affect trusts that have made capital gains or received franked distributions (including any attached franking credits). However, where a trust has not made particular beneficiaries specifically entitled to those amounts, these amendments generally produce the same outcome as under the current law.

2.3 Schedule 2 also amends Division 6 of Part III of the *Income Tax Assessment Act 1936* (ITAA 1936), hereafter referred to as Division 6, to include specific anti-avoidance rules to address the potential opportunities for tax manipulation that can result from the inappropriate use of exempt entities as beneficiaries.

2.4 The legislative references in this chapter are to the ITAA 1997 unless otherwise specified.

- **Context of amendments**

2.5 On 30 March 2010, the High Court handed down its decision in *Commissioner of Taxation v Bamford* (2010) 240 CLR 481. In that case, the Court considered the meaning of ‘income of the trust estate’ and the meaning of ‘share’ for the purposes of section 97 of the ITAA 1936.

2.6 The Court clarified that:

- ‘income of the trust estate’ in section 97 of the ITAA 1936 refers to the distributable income of the trust as determined according to trust law and in accordance with the deed; and
- ‘share’ means ‘proportion’ such that once the share of the distributable income of the trust to which the beneficiary is presently entitled is determined, the beneficiary is assessed on that same percentage share of the trust’s net income as defined in section 95 of the ITAA 1936 (hereafter referred to as the trust’s ‘taxable income’).
 - This interpretation of the term ‘share’ is referred to as the proportionate approach.

2.7 This decision has highlighted a number of longstanding problems with the taxation of trusts. In particular, it has highlighted that the amounts on which a beneficiary is assessed do not always match the amounts that they are entitled to under

trust law. This mismatch can result in unfair outcomes, as well as opportunities for tax manipulation.

2.8 The decision has also raised issues about how the proportionate approach interacts with other areas of the tax law. For example, it is not clear how the proportionate approach interacts with provisions in the tax law that assume, or provide for, amounts (such as capital gains and franked distributions) to have the same character in the hands of a beneficiary as they had in the hands of a trustee.

2.9 This is because, under the proportionate approach, the amount included in a beneficiary's assessable income under Division 6 is the proportion of the income of the trust estate to which a beneficiary is presently entitled applied against 'the whole of the trust's taxable income'. On one view, the result of this approach is that a beneficiary includes in their assessable income a 'blended' amount of all of the different types of income and capital gains included in the trust's taxable income.

- **Government response**

2.10 On 16 December 2010, in recognition of the longstanding problems with the taxation of trusts, the Government announced a public consultation process as the first step towards updating the trust income tax provisions and rewriting them into the ITAA 1997.

2.11 The Government also announced that it would obtain advice from the Board of Taxation (Board) on whether there are any issues with the current operation of the trust income tax provisions that must be addressed from the 2010-11 income year as an interim measure pending the broader review of the taxation of trust income.

2.12 On 4 March 2011, after examining the advice provided by the Board, the Government announced that it would:

- better align the concept of 'income of the trust estate' with 'net income of the trust estate'; and
- enable the 'streaming' of capital gains and franked distributions.

2.13 The Government subsequently released the discussion paper, *Improving the taxation of trust income* for public consultation on options to implement the Board's recommendations.

2.14 After consulting with interested stakeholders, the Assistant Treasurer and Minister for Financial Services and Superannuation confirmed via Media Release No. 052 of 13 April 2011 that the Government would defer consideration of the proposal to better align the concept of 'income of the trust estate' with 'net income of the trust estate' until the broader review of the taxation of trust income.

2.15 As a result of this decision, the Assistant Treasurer and Minister for Financial Services and Superannuation also announced (in Media Release No. 052) that specific anti-avoidance rules would be introduced to target the use of exempt entities to inappropriately reduce the tax otherwise payable on the taxable income of a trust. These rules are designed to address the potential opportunities for tax manipulation that would otherwise exist, in the interim, while the Government continues with its broader update and rewrite of the trust income tax provisions.

2.16 Further, as a result of consultation on exposure draft legislation, the Government has provided a carve-out for managed investment trusts (MITs) and certain trusts treated like MITs in recognition that these trusts generally do not 'stream' capital gains or franked distributions and instead distribute all of their trust income proportionally. This carve-out enables MITs to use the current 'proportional approach' in Division 6 until the Government's new MIT regime commences on 1 July 2012. The

trustees of these trusts can still choose to apply these amendments provided they make a valid election for the 2010-11 or 2011-12 income year.

2.17 The Government also recognises that it would be difficult for MITs to engage in the kind of tax manipulation that the specific anti-avoidance rules are designed to target. Therefore, those rules do not apply to MITs (even if they choose to apply the other amendments in this Schedule).

2.18 The Government is aware that these amendments do not address all of the current problems and uncertainties related to the taxation of trusts. However, these amendments address key anomalous outcomes and provide certainty in relation to the streaming of capital gains and franked distributions (including any attached franking credits).

2.19 The Government remains committed to considering issues with the taxation of trusts more broadly as part of its announced update and rewrite of the trust income tax provisions.

• **Summary of new law**

2.20 These amendments ensure that, for the 2010-11 and later income years, where a trustee has the power to appoint or 'stream' capital gains and/or franked distributions (including any attached franking credits) to specific beneficiaries this will be effective for tax purposes, subject to relevant integrity rules.

2.21 To achieve this result, capital gains and franked distributions are effectively taken out of Division 6 and dealt with under Subdivision 115-C and 207-B respectively.

2.22 These amendments also introduce the concept of specific entitlement to ensure that a beneficiary's 'share' of the trust's capital gains and franked distributions (including any attached franking credits) reflects their entitlement under the relevant trust deed.

2.23 These amendments also introduce specific anti-avoidance rules that prevent the inappropriate use of exempt beneficiaries to 'shelter' taxable income of a trust.

2.24 Broadly, the specific anti-avoidance rules apply where a beneficiary that is an exempt entity is not notified or paid their present entitlement to income of the trust; or where an exempt beneficiary would otherwise be assessed on a share of a trust's taxable income that is disproportionate to their overall trust entitlement.

- **Comparison of key features of new law and current law**

• <i>New law</i>	• <i>Current law</i>
<p>Where a beneficiary is specifically entitled to a capital gain included in the trust's taxable income, that beneficiary is treated as having made a capital gain (or a trustee is assessed and liable to pay tax on their behalf on an equivalent amount).</p>	<p>Net capital gains form part of the trust's taxable income assessed under Division 6. In addition, so much of the amount assessed to a beneficiary under Division 6 that is attributable to a capital gain of the trust forms the basis of an extra capital gain taken to be made by that beneficiary under Subdivision 115-C.</p> <p>Beneficiaries entitled to property of the trust representing a capital gain but who are not entitled to any income of the trust estate are not taken to have made such a capital gain.</p> <p>Special rules also apply to trustees assessed under Division 6.</p>
<p>A trustee of a resident trust can choose to be assessed on a capital gain of the trust if no amount of trust property referable to the capital gain is paid or applied for the benefit of a beneficiary.</p>	<p>A trustee of a resident testamentary trust can choose to be assessed on a capital gain of the trust if the capital gain would otherwise be assessed to a beneficiary who cannot benefit from it (or the trustee would be assessed and liable to pay tax on behalf of such a beneficiary).</p>
<p>Where a beneficiary is specifically entitled to a franked distribution, that beneficiary (or a trustee assessed and liable to pay tax on their behalf) is assessed on the amount of the franked distribution included in the taxable income of the trust estate and on the franking credits attached to that distribution.</p>	<p>Franked distributions and their attached franking credits form part of the taxable income of the trust assessed under Division 6.</p> <p>Subdivision 207-B contains rules for working out beneficiaries' (and, where relevant, the trustee's) share of the attached franking credits.</p>
<p>Amounts otherwise assessable to beneficiaries (and, where relevant, the trustee) under Division 6 are adjusted to ensure that capital gains, franked distributions and franking credits dealt with under Subdivision 115-C and 207-B respectively are not taxed twice.</p>	<p>Double taxation is avoided in respect of extra capital gains calculated under Subdivision 115-C through the deduction provided for by subsection 115-215(6).</p> <p>Whilst subsection 207-35(3) is said to operate 'despite' Division 6, Subdivision 207-B contains no equivalent to subsection 115-215(6).</p>
<p>An exempt entity is taken <i>not</i> to be presently entitled to any amount of the trust's income unless they have either been paid or notified of their entitlement, within two months of the end of the income year.</p> <p>The amount that would otherwise be that beneficiary's share of taxable income is assessed to the trustee.</p>	<p>No equivalent.</p>
<p>Where an exempt entity is used to</p>	<p>An exempt entity can be made</p>

• <i>New law</i>	• <i>Current law</i>
‘shelter’ a share of the taxable income of a trust that exceeds the exempt entity’s entitlement to the net accretions to the trust underlying that taxable income (whether ‘income’ or ‘capital’ of the trust), that excess is assessed to the trustee.	presently entitled to all of the income of a trust estate (as calculated under trust law) resulting in the trust’s total taxable income becoming exempt — even where the entity is not entitled to receive all of the net taxable accretions to the trust underlying that taxable income (whether ‘income’ or ‘capital’ of the trust).

• **Detailed explanation of new law**

2.25 The primary purpose of these amendments is to ensure that, where permitted by a trust deed, the ‘streaming’ of capital gains and franked distributions to beneficiaries (by making them specifically entitled to those amounts) is effective for tax purposes.

2.26 To achieve this goal, the taxation of a trust’s capital gains and franked distributions (including attached franking credits) is effectively taken out of Division 6 and dealt with under Subdivisions 115-C and 207-B.

2.27 These amendments do not apply to a MIT unless the MIT opts in to the amendments (see paragraphs 2.208 to 2.212).

2.28 For trusts with no capital gains and no franked distributions, the streaming amendments have no effect. However, the specific anti-avoidance rules may still apply. *[Schedule 2, item 7, section 102UW of the ITAA 1936]*

2.29 For trusts that have capital gains or franked distributions but do not stream them to specific beneficiaries, the amendments apply but they will generally produce the same outcome as the current law.

- There is a minor improvement to the way double taxation is avoided for capital gains (see paragraph 2.80).

2.30 This part of the explanatory memorandum explains:

- the order in which to apply the new provisions (see paragraphs 2.31 to 2.34);
- when streaming of capital gains and franked distributions will be effective for tax purposes and what is required for a beneficiary to be ‘specifically entitled’ to these amounts (see paragraphs 2.35 to 2.70);
- calculating the ‘adjusted Division 6 percentage’ for the purposes of Subdivisions 115-C and 207-B (see paragraphs 2.71 to 2.75);
- the treatment of capital gains under Subdivision 115-C (see paragraphs 2.76 to 2.113);
- the treatment of franked distributions and franking credits under Subdivision 207-B (see paragraphs 2.114 to 2.149);
- the application of new Division 6E of the ITAA 1936 (hereafter referred to as Division 6E) to adjust the assessable amounts under Division 6 (see paragraphs 2.150 to 2.164);
- the combined effect of the streaming amendments (see paragraphs 2.165 to 2.169); and

- the specific anti-avoidance rules for exempt entities that are used to ‘shelter’ taxable income of a trust disproportionately to their entitlements (see paragraphs 2.170 to 2.202).

- **The order in which to apply the provisions**

2.31 As is currently the case, Division 6 is the starting point for the taxation of trust income. Broadly, Division 6 makes beneficiaries assessable on a share of a trust’s taxable income based on their share of the income of the trust estate. It also generally assesses the trustee on any residual taxable income where there is part of the trust’s income to which no beneficiary is presently entitled. If the trust has no (net) taxable income or no capital gains and no franked distributions, the trustee (and beneficiaries) need go no further. [*Schedule 2, item 1, section 95AAA of the ITAA 1936*]

2.32 The next step is to determine amounts of capital gains and franked distributions to which beneficiaries are specifically entitled — and each beneficiary’s ‘adjusted Division 6 percentage’ of the remaining income of the trust estate. These concepts are used to calculate each beneficiary’s ‘share’ of the trust’s capital gains and franked distributions. Generally, if no capital gains or franked distributions have been streamed to specific beneficiaries, each beneficiary’s adjusted Division 6 percentage will be the same as their original Division 6 percentage of trust income.

2.33 Third, the amended Subdivisions 115-C and 207-B apply to assess beneficiaries (or the trustee) on their ‘share’ of any capital gain made or franked distributions derived by the trustee. It does not matter which Subdivision you apply first. Technically, the two Subdivisions operate simultaneously.

2.34 Finally, Division 6E applies to adjust the amounts otherwise assessed to a beneficiary (or the trustee) under Division 6. In effect, you calculate these Division 6 assessable amounts assuming the trust had no capital gains or franked distributions. However, for trustee assessments, Division 6E does not affect the amounts brought to tax under Subdivisions 115-C and 207-B.

- **When ‘streaming’ is effective for tax purpose — ‘specifically entitled’**

2.35 These amendments ensure that where a trustee has a power to stream under the terms of the trust, the streaming will be effective for tax purposes. These amendments do not in any way *give* trustees a power to stream where they do not already have the power to do so.

2.36 Existing integrity rules in Subdivision 207-F (such as the ‘qualified person’ rules) continue to apply in respect of the streaming of franked distributions — particularly to determine whether the beneficiary can receive the benefit of franking credits.

2.37 For streaming of capital gains and franked distributions to be effective for tax purposes, beneficiaries must be specifically entitled to them. That is:

- the beneficiary must receive, or reasonably be expected to receive, an amount equal to the ‘net financial benefit’ referable to the capital gain or franked distribution in the trust; and
- the entitlement must be recorded in its character as such in the accounts or records of the trust (see paragraph 2.62).

[*Schedule 2, item 11, section 115-228, item 24, section 207-58 and item 27, subsection 995-1(1)*]

2.38 Broadly, a beneficiary will be specifically entitled to the fraction of the (gross) tax amount that equals their fraction of the net trust amount referable to the capital gain or franked distribution. For example, a beneficiary that receives an amount specified to be half of the trust’s profit from the sale of an asset will generally be specifically entitled

to half of the (tax) capital gain realised on the asset. [*Schedule 2, item 11, subsection 115-228(1) and item 24, subsection 207-58(1)*]

2.39 When a beneficiary has a specific entitlement to a capital gain or franked distribution, the associated tax consequences in respect of that distribution will apply to that beneficiary. Furthermore, the beneficiary will not be assessed on any share of the trust's taxable income over and above the amounts assessed because of Subdivisions 115-C and 207-B.

2.40 Capital gains and franked distributions to which no beneficiary is specifically entitled will flow proportionally to beneficiaries and/or the trustee based on their share of income of the trust *excluding* amounts to which any beneficiary is specifically entitled. This 'adjusted Division 6 percentage' is explained further in paragraphs 2.71 to 2.75.

• ***The meaning of 'receive or reasonably be expected to receive'***

• *What must the beneficiary receive or reasonably be expected to receive?*

2.41 A beneficiary must receive, or reasonably be expected to receive, an amount equal to their 'share of the net financial benefit' that is referable to the capital gain or franked distribution. [*Schedule 2, item 11, subsection 115-228(1) and item 24, subsection 207-58(1)*]

2.42 This does not require an 'equitable tracing' to the actual trust proceeds from the event that gave rise to a capital gain or the receipt of a franked distribution. For example, it does not matter that the proceeds from the sale of an asset or a franked distribution were re-invested during the year, provided that a beneficiary receives (or can be expected to receive) an amount equivalent to their share of the net financial benefit.

2.43 The entitlement can be expressed as a share of the trust gain or distribution. More generally, the entitlement can be expressed using a known formula even though the *result* of the formula is calculated later. For example, a trustee could resolve to distribute to a beneficiary:

- \$50 referable to a franked distribution;
- half of the 'trust gain' realised on the sale of an asset;
- the amount of franked distribution remaining after calculating directly relevant expenses and distributing \$10 to another beneficiary;
- thirty per cent of a 'net dividends account' that includes all franked and unfranked distributions, less directly relevant expenses charged against the account (so long as their entitlement to net *franked* distributions can be determined); and
- the amount of (tax) capital gain included in the calculation of the trust's taxable income remaining after the application of the capital gains tax (CGT) discount. (In such a case the beneficiary would generally be specifically entitled to only half of the gain, and that entitlement is taken to be made up equally of the taxable and discount parts of the gain.)

• *When a beneficiary has received or can reasonably be expected to receive*

2.44 A beneficiary has received an amount when, for example, it has been credited or distributed to them (including under a re-investment agreement), or paid or applied on their behalf or for their benefit.

2.45 A beneficiary can reasonably be expected to receive an amount if, for example, the beneficiary has a present entitlement to the amount; a vested and indefeasible interest in trust property representing the amount; or, the amount has been set aside exclusively for the beneficiary. In other words, even if the beneficiary is not 'presently entitled' to the trust amount, it is reasonable to expect that the beneficiary *will* become entitled to it.

Example 2.1

In June 2011, the Straddle Trust signed a contract for the sale of a property for \$500,000 with a settlement date in October 2011. The trustee purchased the property in 2006 for \$300,000.

Upon settlement of the contract, the trustee will be taken to have made a capital gain at the time when the contract was entered into. Therefore, the trust will have a capital gain of \$200,000 in the 2010-11 income year.

In accordance with the trust deed, in July 2011 the trustee resolves to distribute all of the trust profit on the sale to Bob upon settlement.

Bob can reasonably be expected to receive the trust profit on the sale of the asset and is specifically entitled to the capital gain for the purposes of the 2010-11 income year.

2.46 A notional allocation of an amount by a trustee to a beneficiary (for example, in the trust's tax records) is not sufficient because there is no reason to reasonably expect that the beneficiary will receive the amount.

- **'Net financial benefit'**

2.47 A **net financial benefit** is the 'financial benefit' or actual proceeds of the trust (irrespective of how they are characterised) reduced by (trust) losses or expenses (subject to certain conditions explained below). [*Schedule 2, item 11, subsection 115-228(1) and item 24, subsection 207-58(1)*]

- **Financial benefit**

2.48 **Financial benefit** is defined in existing section 974-600 to mean anything of economic value (including property and services). It includes a receipt of cash or property, an increase in the value of units in a unit trust, the forgiveness of a debt obligation of the trust or any other accretion of value to the trust.

- **Reduced by losses or expenses**

2.49 These amendments do not impose any rules on how trustees can apply losses within the trust generally. However, for the purposes of determining specific entitlement, there are conditions on which (trust) losses or expenses can be taken into account to reduce the (gross) financial benefit.

2.50 When determining a beneficiary's fraction of the net financial benefit referable to a 'capital gain', the (gross) financial benefit referable to the gain is reduced by *trust* losses or expenses only to the extent that *tax* capital losses were applied in the same way. [*Schedule 2, item 11, subsection 115-228(1)*]

2.51 When determining a beneficiary's fraction of the net financial benefit referable to a 'franked distribution', the (gross) financial benefit is reduced by *directly relevant* expenses only. [*Schedule 2, item 24, subsection 207-58(1)*]

Example 2.2

A trust sells Asset A for a gain of \$1,000 and Asset B for a gain of \$2,000. The trust also sells another asset for a capital loss of \$500. (The amounts are the same for trust and tax purposes.)

The trustee resolves to distribute \$500 to Jo, recorded as referable to the gain on Asset A after being reduced by the capital loss, and \$2,000 to Tanya, recorded as referable to the gain on Asset B. However, for tax purposes, the trustee applies the capital loss against the capital gain on Asset B.

Therefore, the net financial benefit referable to the capital gain on Asset A is \$1,000, and Jo is only specifically entitled to half of the capital gain.

The net financial benefit referable to the capital gain on Asset B is \$2,000 (because the trustee did not apply any *trust* losses against the *trust* gain) and Tanya is specifically entitled to all of the capital gain.

- *Exception for capital gains and the market value substitution rule*

2.52 No beneficiary can be specifically entitled to the part of a (tax) capital gain that arises because of the market value substitution rules in sections 112-20 and 116-30. In these cases, the amount of specific entitlement is limited to what the (tax) capital gain would have been if the market value substitution rules did not apply. [*Schedule 2, item 11, subsection 115-228(3)*]

- *Referable to a capital gain or franked distribution*

2.53 The net financial benefit referable to a franked distribution will normally equal the amount of the franked distribution after being reduced by directly relevant expenses. Directly relevant expenses could include any annual borrowing expenses (such as interest) incurred in respect of the underlying shares (allocated rateably against any franked and unfranked dividends from those shares) or management fees incurred in respect of managing an investment portfolio of shares for the purpose of deriving dividend income (allocated against dividend income as relevant). [*Schedule 2, item 24, subsection 207-58(1)*]

2.54 The net financial benefit referable to a capital gain will generally be the trust proceeds from the transaction or circumstances that gave rise to the CGT event, reduced by any costs incurred in relation to the relevant asset. This may be further reduced by other trust losses of a capital nature (to the extent consistent with the application of capital losses for tax purposes). [*Schedule 2, item 11, subsection 115-228(1)*]

2.55 What matters is the financial benefit to the trust over the life of the relevant asset, not just in the year of the CGT event.

Example 2.3

The Zhang Trust buys an investment property in 2001 for \$100,000. The trustee of the trust has the power to revalue the property according to generally accepted accounting principles and treat any increase in its value as income of the trust.

Each year for the following 10 income years, the trustee revalues the asset upwards by \$20,000 and treats this amount as income of the trust. For each of the first five years, the trustee distributed \$20,000 from the revaluation to John, who is no longer a beneficiary of the trust. For each of the remaining five years, the trustee distributed \$20,000 from the revaluation to Kevin (who is still a beneficiary of the trust).

In the 2011-12 income year, the trustee sells the property for \$400,000. The trustee makes an accounting gain of \$100,000 (\$400,000 less the revalued amount of \$300,000) and a (tax) capital gain of \$300,000 (\$400,000 capital proceeds minus the cost base of \$100,000).

The trustee distributes the \$100,000 accounting gain to William.

Assuming there are no losses or expenses, the net financial benefit referable to the gain (over the life of the asset) is \$300,000. After applying the CGT discount, the taxable capital gain is \$150,000.

Kevin received a \$100,000 share of the net financial benefit referable to the gain (in five payments of \$20,000) and therefore is specifically entitled to one third of the \$300,000 capital gain.

William also received a \$100,000 share of the net financial benefit referable to the gain (one payment of \$100,000) and is also specifically entitled to one third of the \$300,000 capital gain.

There is one third of the capital gain to which no beneficiary is specifically entitled. (John cannot be specifically entitled to any of the capital gain because he is no longer a beneficiary.)

- *No one can be specifically entitled to a notional or zero amount*

2.56 It is not possible to stream tax amounts to beneficiaries where there is no referable net financial benefit remaining in the trust — such as when the gross benefit has been reduced to zero by losses or directly relevant expenses.

[Schedule 2, item 11, subsection 115-228(1) and item 24, subsection 207-58(1)]

Example 2.4

The Baguley Trust derives net rental income of \$100,000 and a franked distribution of \$70,000 (with \$30,000 attached franking credits) from shares in TAS Pty Ltd. The trustee had interest expenses of \$100,000 on a loan taken out to purchase the shares in TAS Pty Ltd. As a result, there are no net franked dividends.

The trust's income is \$70,000 and the taxable income is \$100,000.

The Baguley Trust has two beneficiaries, Justin and Kerry. Under the terms of the trust, Justin is entitled to net franked dividends and Kerry is entitled to all other income.

Justin has no entitlement to income as the trust has no net dividend income. He is also not specifically entitled to anything as there is no net franked dividend to which he can be specifically entitled.

By contrast, Kerry is entitled to all of the trust's income (\$70,000).

As Kerry is entitled to all of the income of the trust and as no-one was specifically entitled to any of the franked distribution, Kerry's share of the franked distribution equals all of the distribution (section 207-55). It follows that she receives all of the franking credits (section 207-57).

2.57 However, if the trustee deals with all of the franked distributions received by the trust as a single 'class' (or as part of a broader class), the provisions apply to the total franked distributions as if they were a single franked distribution. Therefore, if a beneficiary is entitled to receive all (or a share) of the entire class of net franked distributions of a trust and the class is in an overall gain position, the beneficiary can be specifically entitled to all (or that share) of the entire class of franked distributions, even if a particular franked distribution was more than offset by directly relevant expenses. What matters is that the trustee *distributes* the franked distributions as a single class. It is not sufficient (or necessary) that the trustee records the *receipt* of the franked distributions as a single class. [Schedule 2, item 24, section 207-59]

Example 2.5

Continuing Example 2.4, but suppose the Baguley Trust also derives a \$70,000 franked distribution (with \$30,000 attached franking credits) from RFP Pty Ltd, with no directly relevant expenses. Therefore, the trust has net franked dividends of \$40,000.

The trust's income is \$140,000 and the taxable income is \$200,000 (including \$60,000 franking credits).

Justin is entitled under the deed to \$40,000 (the net franked dividends). As a result, he is specifically entitled to all of the franked dividends of the trust (section 207-58). It follows that he receives all of the franking credits of \$60,000 (sections 207-55 and 207-57). He includes \$100,000 in his assessable income under Subdivision 207-B.

Kerry receives \$100,000 from the trust and \$100,000 is included in her assessable income under section 97 of the ITAA 1936 (as modified by Division 6E).

- *No one can be specifically entitled to a 'deemed gain'*

2.58 Generally, no beneficiary can be specifically entitled to a purely notional gain — that is, a deemed gain for tax purposes such as deemed capital gains from a trust ceasing to be a resident trust. This is because there is no net economic benefit referable to the notional gain that beneficiaries can receive.

2.59 However, whether a beneficiary can be specifically entitled to a capital gain or franked distribution is a question of fact. For example, when a beneficiary becomes absolutely entitled to a trust asset, it may be reasonable to expect the beneficiary will receive the net financial benefit referable to the deemed (trust) capital gain from CGT event E5.

• ***A beneficiary cannot be specifically entitled to franking credits***

2.60 It is not possible to make a beneficiary specifically entitled to franking credits, or to separately stream franked distributions and franking credits.

2.61 There is no change to the current rules that allow franking credits to flow proportionally to beneficiaries that have a share of a trust's (positive) net income for an income year notwithstanding that the franked distributions of the trust were entirely offset by expenses.

• ***Recorded in its character as a capital gain/franked distribution***

2.62 The amount (or fraction) of the net economic benefit that the beneficiary has received or can reasonably be expected to receive must also be recorded *in its character* as referable to the capital gain or franked distribution in the accounts or records of the trust. [Schedule 2, item 11, paragraph 115-228(1)(c) and item 24, paragraph 207-58(1)(c)]

2.63 The accounts or records of the trust would include the trust deed itself, statements of resolution or distribution statements, including schedules or notes attached to, or intended to be read with them. However, a record merely for tax purposes is not sufficient.

2.64 The following resolutions or trust entitlements would satisfy the requirement of being 'recorded in its character as referable':

- Under the trust deed, a beneficiary is entitled to all of the capital gains of the trust.
- The trustee resolves to distribute all of the dividends of the trust to a beneficiary.
- Under a trust deed that includes capital gains as income (either by default or because the trustee exercises a power to re-characterise the amount as income), a beneficiary is entitled to all of the profits made on or derived from an asset.
- Under a trust deed that does not include capital gains as income, the trustee resolves to advance capital representing profits from the sale of a property equally to the beneficiaries.

• ***Entitlement to unspecified amounts such as 'the balance' is not sufficient***

2.65 Where a beneficiary is entitled to unspecified amounts (or shares) — such as 'the balance' of trust income, 'all of the trust income', 'half of the trust income' or '\$100 of trust income' — this is not sufficient to create a specific entitlement. This is because the entitlements have not been recorded *in their character* as referable to a capital gain or franked distribution.

- This is true even if the beneficiary's entitlement contains amounts referable to capital gains or franked distributions.
- Further, it is true even if the beneficiary's entire entitlement is referable to capital gains and/or franked distributions.

- **When the record must be made by**

2.66 For capital gains, a beneficiary's entitlement must be recorded no later than two months after the end of the income year. [Schedule 2, item 11, paragraph 115-228(1)(c)]

2.67 For franked distributions, a beneficiary's entitlement must be recorded by the end of the income year. [Schedule 2, item 24, paragraph 207-58(1)(c)]

- **Creating specific entitlement through a chain of trusts**

2.68 Specific entitlement to a capital gain or a franked distribution can be created through a chain of trusts by meeting the requirements for specific entitlement at each 'step'.

2.69 For example, if a beneficiary is specifically entitled to a capital gain from a trust in its capacity as trustee of a second trust, the 'trustee beneficiary' will have an extra capital gain for the purposes of calculating its net income. The trustee of the second trust may then be able to make a beneficiary specifically entitled to that extra capital gain.

Example 2.6

First Trust makes a (trust) gain of \$90,000 on the sale of an asset. The (non-discount) capital gain for tax purposes is \$100,000.

The trustee of First Trust resolves to distribute the \$90,000 gain to Zandra in her capacity as trustee of Second Trust. Zandra is specifically entitled to the entire capital gain of \$100,000. When calculating the net income of Second Trust, Zandra therefore has an extra capital gain of \$100,000 under subsection 115-215(3).

Zandra resolves to distribute to Ralph \$40,000 referable to the extra capital gain after applying a loss of \$50,000 against Second Trust's \$90,000 financial benefit in a way consistent with the application of a capital loss against the \$100,000 (tax) capital gain.

Ralph is specifically entitled to the \$100,000 (extra) capital gain. He has an attributable gain under subsection 115-225(1) of \$50,000 (taking into account the capital loss).

2.70 Where a capital gain or franked distribution flows proportionally from one trust to another, it may still be possible for the second trust to create a specific entitlement to its share of the capital gain, *provided* that the second trust received a referable financial benefit from the first trust that can then be specifically allocated to a beneficiary of the second trust.

- **Calculating the 'adjusted Division 6 percentage'**

2.71 Where a trustee does not stream part or all of a capital gain or franked distribution, the amounts not streamed flow proportionally to beneficiaries (or the trustee). This proportion is based on a taxpayer's 'adjusted Division 6 percentage' and *not* their (original) share of the income of the trust estate under Division 6. However, where no capital gains or franked distributions have been streamed to specific beneficiaries, the two percentage shares will be the same.

2.72 Broadly, a beneficiary's 'adjusted Division 6 percentage' is their share of the income of a trust excluding capital gains and franked distributions to which *any* beneficiary (or the trustee) is specifically entitled. The amounts are excluded only to the extent they were part of the income of the trust in the first place.

2.73 That is, the 'adjusted Division 6 percentage' is calculated as:

- **the beneficiary's present entitlement to trust income excluding any capital gains or franked dividends to which they are specifically entitled; divided by**

- **the income of the trust excluding any capital gains or franked distributions to which any entity is specifically entitled.**

[Schedule 2, items 2, 4 and 5, subsection 95(1) of the ITAA 1936 and item 25, subsection 995-1(1)]

2.74 **If the sum of beneficiaries' adjusted Division 6 percentage is less than 100 per cent, the difference is the trustee's adjusted Division 6 percentage.** If there is no income of the trust remaining after disregarding amounts to which any entity is specifically entitled, the trustee has an adjusted Division 6 percentage of 100 per cent. [Schedule 2, items 2 and 4, subsection 95(1) of the ITAA 1936 and item 25, subsection 995-1(1)]

Example 2.7

In the 2010-11 income year, the Lang Trust received \$100,000 of rental income and \$70,000 of fully franked distributions. The trust has no expenses. Its income is therefore \$170,000 and its taxable income is \$200,000 (including the \$30,000 franking credit attached to the distribution).

The trust has two beneficiaries Hannah and Lucy. The trustee of the Lang Trust in accordance with a power under the deed makes Hannah presently and specifically entitled to \$50,000 of the franked distributions and additionally entitled to so much of the remainder of the trust's income as to make her total present entitlement equal to 50 per cent of the income of the trust.

Lucy is presently entitled to 50 per cent of the income of the trust.

Hannah's Division 6 percentage is 50 per cent as she is entitled to half of the income of the trust estate. Lucy's Division 6 percentage is likewise 50 per cent.

However, Hannah's adjusted Division 6 percentage is 29 per cent ($\$85,000 - \$50,000 / (\$170,000 - \$50,000)$), being Hannah's entitlement to income disregarding her specific entitlement to \$50,000 of the distribution divided by the adjusted income of the trust of \$120,000 disregarding the \$50,000 of the income to which Hannah is specifically entitled. Lucy's adjusted Division 6 percentage is 71 per cent ($\$85,000 / \$120,000$).

2.75 The calculation of adjusted Division 6 percentage only excludes capital gains or franked distributions to which an entity is specifically entitled (to the extent they were part of the income of the trust) — it does *not* exclude all capital gains and franked distributions. Division 6E is not relevant for the calculation of the adjusted Division 6 percentage.

- **Treatment of capital gains under amended Subdivision 115-C**

2.76 The existing Subdivision 115-C sets out rules for dealing with the taxable income that relates to capital gains of a trust.

2.77 Broadly, the purpose of the amendments to Subdivision 115-C is to ensure that capital gains are assessed to those beneficiaries that are specifically entitled to them.

2.78 That is, the taxable capital gains of a trust are taken into account in working out the net capital gain or loss of beneficiaries that are specifically entitled to the related trust amounts — regardless of whether the related amounts are part of the income or capital of the trust estate.

2.79 **Capital gains are allocated on a 'proportionate' basis to the extent that no one is specifically entitled to part or all of a capital gain.**

- That is, where there is an amount of a capital gain to which no one is specifically entitled, beneficiaries are allocated a proportionate share of that part of the gain based on their (adjusted) share of the income of the trust estate.
- Trustees are similarly allocated a proportionate share of an amount of a capital gain to which no one is specifically entitled — but only to the extent

that there is an (adjusted) share of the income of the trust estate to which no beneficiary is presently entitled.

• **Changes to the general application of Subdivision 115-C**

2.80 Beneficiaries no longer need to have an amount of assessable income included under section 97, 98A or 100 of the ITAA 1936 to be treated as having an extra capital gain under section 115-215. This ensures that a ‘capital beneficiary’ that is specifically entitled to an amount representing a capital gain of a trust is treated as having an extra capital gain in relation to that amount even if they are not presently entitled to a share of the income of the trust estate. [Schedule 2, item 9, subsection 115-215(3)]

2.81 Beneficiaries also no longer receive a deduction for extra capital gains they have as a result of Subdivision 115-C. Instead, the amount included in a beneficiary’s assessable income calculated under Division 6 is modified by Division 6E, if necessary, to exclude any amount of the taxable income of the trust related to the capital gain. [Schedule 2, item 8, section 115-200 and item 10]

2.82 Subdivision 115-C may also increase the amount on which a trustee is assessed, either under section 98 of the ITAA 1936 (on behalf of a beneficiary) or under section 99 or 99A of the ITAA 1936. This does not lead to double taxation, because the amounts included directly under Division 6 of the ITAA 1936 are adjusted appropriately. [Schedule 2, item 11, sections 115-220 and 115-222]

• **Calculating the amount of extra capital gain for a beneficiary**

2.83 There are four steps to calculate a beneficiary’s extra capital gain.

- First, determine the beneficiary’s ‘share of the capital gain’ of the trust — this is defined as an ‘amount’ of the gain.
- Second, divide that amount by the (total) capital gain — this gives the beneficiary’s ‘fraction’ of the capital gain.
- Third, multiply that fraction by the taxable income of the trust that relates to the capital gain. The result is the ‘attributable gain’.
- Fourth, gross up the result of step three as appropriate for any CGT concessions (the general CGT discount or the small business 50 per cent reduction) applied by the trustee to that capital gain.

[Schedule 2, item 9, subsection 115-215(3) and item 11, sections 115-225 and 115-227]

2.84 This calculation applies on a ‘gain by gain’ basis for each capital gain of the trust.

• **Step 1 — determine the beneficiary’s share of the capital gain of the trust**

2.85 A beneficiary’s share of a trust capital gain is:

- the amount of the capital gain to which the beneficiary is specifically entitled; plus
- the beneficiary’s adjusted Division 6 percentage of the amount of the capital gain to which no beneficiary is specifically entitled (see paragraphs 2.71 to 2.75).

[Schedule 2, item 11, section 115-227 and item 26, subsection 995-1(1)]

2.86 As described in paragraphs 2.35 to 2.70, a beneficiary that receives all of the net financial benefit referable to a capital gain (after the application of relevant losses) may be specifically entitled to the entire (tax) capital gain. For the purposes of determining specific entitlement only, the losses (a trust concept) must be applied in a way that is consistent with how the trustee applies capital losses for tax purposes.

2.87 Where a beneficiary has received (or can reasonably be expected to receive) an amount referable to a capital gain, that beneficiary will generally be assessable in respect of that capital gain. It does not matter whether all or part of that amount is part of the income of the trust estate.

2.88 Similarly, because the beneficiary's entitlement must be to a trust amount (the net financial benefit) and not a tax concept, it is not effective for tax purposes to stream the 'taxable component' to one beneficiary and the tax-free 'discount component' to another beneficiary. A beneficiary who is only entitled to the 'taxable component' will generally only be specifically entitled to half of the capital gain.

Example 2.8

The Little Trust generated \$100 of rent and a \$600 capital gain (which was a discount capital gain). The trust also had a capital loss of \$100.

The trust deed does not define 'income' and therefore capital gains do not form part of the trust income. As a result, the income of the trust estate is \$100 and the taxable income is
 $\$350 (\$100 + (\$600 - \$100)/2)$

The trustee resolves to distribute \$300 related to the capital gain (after absorbing the capital loss) to Catherine and the \$100 of rent to Aaron.

Catherine is specifically entitled to 60 per cent of the \$600 capital gain under subsection 115-228(1) because she can reasonably be expected to receive the economic benefit of 60 per cent (\$360) of the \$500 capital gain remaining after accounting for the \$100 capital loss. Under section 115-227, Catherine's share of the capital gain is \$360 (60 per cent of the \$600 capital gain).

Aaron's share of the capital gain is \$240 under section 115-227 because he has an adjusted Division 6 percentage of 100 per cent (since none of the capital gain is treated as trust income) and there is \$240 of the \$600 capital gain to which no one is specifically entitled.

• Step 2 — divide by the total capital gain

2.89 To determine the beneficiary's fraction of the capital gain, simply divide the beneficiary's 'share of the capital gain' by the (total) capital gain.
[Schedule 2, item 11, paragraph 115-225(1)(b)]

Example 2.9

Continuing from Example 2.8, Catherine divides her share of the capital gain (\$360) by the total capital gain (\$600) and therefore has 6/10 of the capital gain under paragraph 115-225(1)(b).

Aaron divides his share of the capital gain (\$240) by the total capital gain (\$600) and therefore has 4/10 of the capital gain under paragraph 115-225(1)(b).

• Step 3 — multiply the beneficiary's fraction of the capital gain by the trust's taxable income relating to the capital gain

2.90 A beneficiary's 'attributable gain' is their fraction of the capital gain multiplied by the taxable income that relates to the capital gain.
[Schedule 2, item 11, subsection 115-225(1)]

2.91 Generally, the taxable income of the trust that relates to the capital gain will be the taxable amount of the capital gain remaining after applying any capital losses or net capital loss to the capital gain and after applying any CGT discounts
[Schedule 2, item 11, paragraph 115-225(1)(a)].

- This would equal the trust's net capital gain assuming the trust only had the one capital gain.

- Consistent with the CGT regime, the trustee can choose the order in which they apply the losses. This may reduce the taxable amount for a particular capital gain to zero.

Example 2.10

Continuing from Example 2.9, the taxable income relating to the capital gain calculated under paragraph 115-225(1)(a) is \$250.

Catherine's attributable gain calculated under subsection 115-225(1) is \$150 ($\$250 - 6/10$).

Aaron's attributable gain calculated under subsection 115-225(1) is \$100 ($\$250 \times 4/10$).

2.92 However, in some circumstances, taxpayers rateably reduce the taxable amount of the capital gain to ensure that beneficiaries and the trustee are not assessed on more than the total taxable income of the trust.

2.93 The rateable reduction applies where the trust's net capital gain and (total) franked distributions (net of directly relevant deductions) are together greater than the taxable income of the trust (excluding franking credits).

[Schedule 2, item 11, subsection 115-225(2)]

- For example, the rateable reduction would apply where a trust's only income is from capital gains and franked distributions and the trust has general management expenses.
- The rateable reduction would also apply where a trust has net capital gains and/or franked distributions and the other sources of income are in an overall tax loss position.

2.94 To make the rateable reduction, multiply the taxable amount of the capital gain by the following formula:

Taxable income of the trust (excluding franking credits)

net capital gain of the trust + 'net franked distributions'

where *net franked distributions* means franked distributions of the trust reduced by directly relevant deductions. *[Schedule 2, item 11, subsection 115-225(3)]*

2.95 The same rateable reduction applies to each capital gain (and to each franked distribution).

Example 2.11

Assume the same facts as Example 2.8, but suppose the trust also had general expenses of \$200. The taxable income of the trust is therefore \$150 and not \$350.

The taxable income related to the capital gain is reduced to \$150 because the net income of \$150 is less than the trust's net capital gain of \$250 (that is, apply subsection 115-225(3) and multiply the taxable amount of the capital gain ($\$250 \times \$150/\$250$).

Catherine's attributable gain calculated under subsection 115-225(1) is therefore \$90 ($\$150 \times 6/10$).

Aaron's attributable gain calculated under subsection 115-225(1) is therefore \$60 ($\$150 \times 4/10$).

- *Step 4 — gross up the amount for CGT discounts applied by the trustee*

2.96 After multiplying the beneficiary's fraction of the capital gain by the taxable income of the trust that relates to the capital gain, the resulting amount is grossed up for any discounts the trustee applied to that gain *[Schedule 2, item 9, subsection 115-215(3)]*.

- If no discounts applied, there is no gross up.

- If either the general CGT discount or the small business 50 per cent reduction applied (but not both), the amount is doubled.
- If both discounts applied, the amount is quadrupled.

2.97 The beneficiary has an extra capital gain equal to the grossed up amount. This lets the beneficiary reduce their extra capital gains by any current or prior year capital losses that they have, and then apply any relevant discounts to work out their own net capital gain. *[Schedule 2, item 9, subsection 115-215(3)]*

Example 2.12

Following on from Example 2.11, subsection 115-215(3) requires Catherine to double her attributable gain of \$90 to an extra capital gain of \$180 because the trustee had applied the 50 per cent CGT discount. Aaron similarly doubles his attributable gain to \$120.

Catherine and Aaron can then apply any capital losses or net capital losses to reduce the capital gain. As they are individuals, they can then apply the 50 per cent CGT discount to any amounts remaining.

• Assessing the trustee in respect of a beneficiary under section 98

2.98 Where a trustee is assessed and liable to pay tax under section 98 of the ITAA 1936 in respect of a beneficiary, the trustee increases the assessable amount to reflect the beneficiary's attributable gain in respect of each capital gain of the trust *[Schedule 2, item 11, section 115-220]*.

- This applies even if the only reason that the section 98 assessment arises is because the beneficiary has a share of a capital gain *[Schedule 2, item 11, subsection 115-220(1)]*.
- That is, section 115-220 will apply where a non-resident beneficiary or a beneficiary under a legal disability is specifically entitled to all or part of a capital gain, regardless of whether they have any entitlement to income of the trust.

2.99 The attributable gain is calculated in the same way as described in steps 1 to 3 above, based on the beneficiary's share of each capital gain. The trustee will generally be liable to be assessed on that amount under section 98 of the ITAA 1936, even if the amount it would otherwise have been assessed on under that section was reduced to nil because of Division 6E.

2.100 The attributable gain is doubled if the capital gain is a discount capital gain and the beneficiary is a company or a beneficiary in the capacity as a non-resident trustee of another trust estate (unless subsection 97(3) of the ITAA 1936 applies to that beneficiary). This effectively removes the effect of the discount from beneficiaries who would not be able to claim the discount had they made the capital gain directly. *[Schedule 2, item 11, paragraph 115-220(1)(b)]*

• Assessing the trustee under section 99 or 99A of the ITAA 1936

2.101 A trustee increases the amount it is assessed and liable to pay tax on under section 99 or 99A of the ITAA 1936 to reflect the trustee's share of each capital gain of the trust. This applies even if the only reason for the section 99 or 99A assessment is because the trustee has a share of a capital gain. *[Schedule 2, item 11, section 115-222]*

2.102 For section 99 assessments, the amount is calculated in the same way as described in steps 1 to 3 above, without the need to gross up the amount for any CGT discounts. *[Schedule 2, item 11, subsections 115-222(1) and (2)]*

2.103 For section 99A assessments, the amount is calculated in the same way as for a beneficiary (including step 4), using the trustee's share of each capital gain. *[Schedule 2, item 11, subsections 115-222(3) and (4)]*

2.104 This treatment removes the benefit of any CGT discounts for a trustee assessed under section 99A of the ITAA 1936, replicating the effect of the repealed section 115-225.

2.105 A trustee can generally only be specifically entitled to an amount of a capital gain if they choose to be assessed on the capital gain under section 115-230.

2.106 Therefore, apart from when they make such a choice, a trustee will generally only have a share of a capital gain if:

- there is no beneficiary specifically entitled to part (or all) of the capital gain; and
- there is a share of the income of the trust estate to which no beneficiary is presently entitled (after disregarding capital gains and net franked distributions to which a beneficiary is specifically entitled) — or there is no trust income.

• ***Option for resident trustee to be assessed on a capital gain***

2.107 If permitted by the trust deed, the trustee of a resident trust may choose to be assessed on a capital gain of the trust, provided no beneficiary has received any amount referable to the gain during the income year or within two months of the end of the income year. The choice must be made in respect of the whole capital gain. [*Schedule 2, items 12, 13, 15, 16 and 17, section 115-230*]

2.108 The trust must be a resident trust estate (within the meaning of Division 6) in the income year in respect of which the choice is made. [*Schedule 2, item 14, subsection 115-230(2)*]

2.109 This is similar to the choice that was available under the repealed section 115-230, but is not limited to testamentary trusts. In particular, it allows the trustee of a trust to pay tax on behalf of:

- an income beneficiary who cannot benefit from the gain; or
- a capital beneficiary who is unable to immediately benefit from the gain.

2.110 If the trustee makes the choice, no beneficiary is treated as having an extra capital gain under Subdivision 115-C. The trustee is also not assessed on behalf of any beneficiary under section 98 of the ITAA 1936. [*Schedule 2, item 17, paragraph 115-230(4)(a)*]

2.111 Instead, the trustee is assessed on the taxable income relating to the capital gain under section 99 or 99A of the ITAA 1936 as appropriate (by way of section 115-222). This is done by deeming the trustee to be specifically entitled to the capital gain. [*Schedule 2, item 17, paragraph 115-230(4)(b)*]

Example 2.13

The Ngo Trust is a resident trust within the meaning of Division 6. It is a unit trust with different income and capital unit-holders.

Under the deed, the capital unit-holders have a vested and indefeasible interest in the capital gains made by the trust, but cannot demand payment of those gains until certain events happen.

The trustee makes a \$200 capital gain. After application of the CGT discount, a net capital gain of \$100 is included in the trust's taxable income.

The capital unit-holders are specifically entitled to the capital gain (the financial benefits referable to that gain being reflected in the value of their units, with the trust deed setting out their entitlement to the capital gains of the trust, in their character as capital gains), but currently have no right to demand payment of it. Without more, they would be treated as having extra capital gains in respect of this gain under

subsection 115-215(3), but would have no corresponding cash flow from which to pay the associated tax liability.

Accordingly, the trustee elects to be assessed on the capital gain under section 115-230.

As a result of this election, the capital unit-holders are not taken to have any extra capital gain. Instead, the trustee is taken to be specifically entitled to the full amount of the gain. The trustee therefore increases its assessable amount under section 99 or 99A of the ITAA 1936 by \$200 (being the amount produced after applying section 115-222).

• ***Interaction with Division 855 — capital gains and foreign residents***

2.112 As is currently the case, a foreign resident beneficiary of a fixed trust may be able to disregard an extra capital gain they make under subsection 115-215(3) if it relates to a CGT event happening to a CGT asset of a trust that is not taxable Australian property.

2.113 Because of the operation of subsection 855-40(3), the trustee of the fixed trust would also not be liable to pay tax on the taxable income relating to the capital gain by way of section 115-220.

• **Treatment of franked distributions and franking credits under Subdivision 207-B**

2.114 Subdivision 207-B contains rules that apply to franked distributions that flow through trusts and partnerships.

2.115 Broadly, tax recognition of franking credits (attached to franked distributions) is achieved through a gross up offset mechanism whereby the beneficiary of a trust that derives a franked distribution includes in their assessable income their share of the franked distribution and their share of the franking credit on the distribution (the gross up). The beneficiary is then, subject to eligibility, entitled to an offset equal to their share of the franking credit on the distribution.

2.116 Integrity rules governing the availability of such an offset are set out within Subdivision 207-F. For example, paragraph 207-150(1)(a) requires that the beneficiary must be a 'qualified person' in relation to the distribution in order to obtain the benefit of any franking credit on that distribution.

• ***Changes to the general application of Subdivision 207-B***

2.117 The amendments in this Schedule alter the operation of Subdivision 207-B as it applies to trusts and their beneficiaries. The operation of Subdivision 207-B as it applies to partnerships is unaffected.

2.118 In relation to trusts and their beneficiaries, these amendments modify the current law to:

- ensure that both an entity's share of the franking credit on a distribution and its share of the franked distribution are dealt with under Subdivision 207-B;
- clarify how an entity's share of a franked distribution within the meaning of section 207-55 is to be calculated;
- provide that where a beneficiary of a trust has a specific entitlement to a share of a franked distribution derived by the trustee, the portion of the distribution taxed to that beneficiary includes so much of the distribution to which the beneficiary is specifically entitled that is reflected in the taxable income of the trust;
- provide that where there is a share of a franked distribution derived by the trustee of a trust to which no beneficiary has a specific entitlement, that

portion is assessed to those beneficiaries presently entitled to income of the trust in proportion to their income entitlements (calculated disregarding any capital gains and franked distributions in respect of which an entity is specifically entitled); and

- ensure that any franked distributions and/or attached franking credits that are subject to the application of Subdivision 207-B are not taxed twice.

• ***Share of franking credit***

2.119 The amendments in this Schedule introduce a new approach to the calculation of an entity's share of the franked distribution which makes use of the concept of a taxpayer being specifically entitled to a portion of a distribution received by a trust. The introduction of the concept of 'specific entitlement' into Subdivision 207-B has necessitated some refinements to item 3 in the table in subsection 207-55(3). These refinements are discussed in detail in paragraphs 2.123 to 2.128. The concept of 'specific entitlement' for the purpose of a franked distribution is discussed in paragraphs 2.132 to 2.136.

2.120 As the share of a franked distribution, calculated under section 207-55, is used in determining an entity's share of the franking credit on a franked distribution under section 207-57, in some circumstances these amendments alter the share of a franking credit that an entity would have otherwise been allocated.

• ***Calculating the attributable franked distribution of a beneficiary or trustee***

2.121 There are three steps involved in calculating the amount of an attributable franked distribution under section 207-37.

- First, determine the beneficiary's or trustees' 'share of the franked distribution' of the trust — this is defined as an 'amount' of the distribution.
- Second, divide that amount by the (total) franked distribution — this gives the beneficiary's or trustee's 'fraction' of the franked distribution.
- Third, multiply that fraction by the amount of the franked distribution (that is, the franked distribution to the extent that an amount remains after reducing the distribution by directly relevant deductions). The result of this multiplication is the attributable franked distribution.

[Schedule 2, item 19, subsection 207-37(1)]

• ***Step 1 — determine the beneficiary's share of the franked distribution***

2.122 A beneficiary's or trustee's share of the franked distribution is a share of the gross amount of the distribution.

2.123 It is calculated in accordance with section 207-55. Previously, where the entity to which the distribution flows is a beneficiary of a trust, item 3 in the table in subsection 207-55(3) had the effect that the beneficiary, in order to calculate its share of the franked distribution, had to determine how much of the franked distribution was 'taken into account' in working out the amounts that they would have been assessed on under Division 6.

2.124 The introduction of the concept of 'specifically entitled' into Subdivision 207-B, to clarify the circumstances in which a trustee can stream franked distributions to specific beneficiaries for tax purposes, has resulted in amendments to item 3 in the table in subsection 207-55(3). [Schedule 2, item 22, subsection 207-55(3)]

2.125 Where a trust receives a franked distribution and the distribution flows through the trust to a beneficiary, the amendments to item 3 mean that the beneficiary's share of the franked distribution is now calculated under subsection 207-55(4) as the sum of:

- the amount of the franked distribution to which the beneficiary is specifically entitled (see paragraph 2.133); and
- the beneficiary's proportionate entitlement to any part of the franked distribution to which no beneficiary is specifically entitled.

[Schedule 2, item 23, subsection 207-55(4)]

2.126 Where a trustee is liable to be assessed and pay tax in respect of a beneficiary under section 98 of the ITAA 1936 (or would be so liable but for another provision in the Act such as Division 6E), subparagraph 207-55(4)(a)(ii) operates to treat the trustee as being specifically entitled to the amount of the franked distribution to which the relevant beneficiary is specifically entitled. *[Schedule 2, item 23, paragraph 207-55(4)(a)]*

2.127 A beneficiary's proportionate share of that part of a franked distribution to which no beneficiary is specifically entitled, is calculated in accordance with paragraph 207-55(4)(b). This amount is the amount of the franked distribution multiplied by the beneficiary's adjusted Division 6 percentage. Again allowance is made for circumstances where a trustee is assessed in respect of a beneficiary under section 98 of the ITAA 1936. *[Schedule 2, item 23, subparagraphs 207-55(4)(b)(i) and (ii)]*

2.128 The concept of a beneficiary's 'adjusted Division 6 percentage' is defined in subsection 995-1(1) to have the same meaning as in subsection 95(1) of the ITAA 1936. This percentage is the Division 6 percentage of a beneficiary or trustee calculated on the assumption that the amount of any capital gains or franked distributions to which any beneficiary or trustee is specifically entitled are disregarded in working out the income of the trust estate. *[Schedule 2, item 2, subsection 95(1) of the ITAA 1936]*

2.129 A trustee assessed and liable to pay tax under section 99 or 99A only has a share of a franked distribution for the purpose of section 207-55 where:

- there is no beneficiary specifically entitled to part (or all) of the franked distribution; and
- there is a share of the income of the trust estate to which no beneficiary is presently entitled.

Example 2.14

A franked distribution of \$70 is made to the trustee of the Harvey Trust in the 2010-11 income year. The trust also has \$100 of interest income for the income year and has incurred a \$50 interest expense on the borrowings used to purchase the share which gave rise to the \$70 distribution. The income of the trust estate is therefore \$120. The taxable income of the trust is \$150 (including the \$30 franking credit attached to the distribution).

The trust has two beneficiaries, Sharon and Audrey. Sharon is presently entitled to 40 per cent of the income of the trust estate. Audrey is presently entitled to the remaining 60 per cent of the income of the trust estate. Neither beneficiary is specifically entitled to any portion of the distribution.

Sharon's share of the franked distribution is \$28 calculated as $(0.4 \times \$70)$.

Audrey's share of the franked distribution is \$42 calculated as $(0.6 \times \$70)$.

- *Step 2 — divide that amount by the (total) franked distribution*

2.130 To determine the beneficiary's or trustee's fraction of the franked distribution simply divide the beneficiary's or trustee's share of the franked distribution by the total franked distribution.

Example 2.15

Continuing on from Example 2.14 Sharon's fraction of the franked distribution is calculated by dividing her share of the franked distribution (\$28) by the total franked distribution (\$70).

Her fraction of the franked distribution is therefore $\$28/\70 or $2/5$ ths.

The same calculation applies for Audrey. Her fraction of the franked distribution is calculated by dividing her share of the franked distribution (\$42) by the total franked distribution (\$70).

Her fraction of the franked distribution is therefore $\$42/\70 or $3/5$ ths

- *Step 3 — multiply that fraction by the taxable income of the trust that relates to the net franked distribution*

2.131 A beneficiary's or trustee's attributable franked distribution is their fraction of the franked distribution multiplied by the amount of the franked distribution to the extent that an amount of the franked distribution remains after reducing it by the deductions that are directly related to it.

Example 2.16

Continuing from Example 2.15 the amount of the franked distribution remaining after reducing it by the \$50 interest deduction is \$20 ($\$70 - \50).

Sharon's attributable franked distribution is therefore \$8, calculated by multiplying $2/5$ ths by \$20.

Audrey's attributable franked distribution is \$12, calculated by multiplying $3/5$ ths by \$20.

2.132 Subsections 207-37(2) and (3) provide for a rateable reduction of the amount otherwise identified as the attributable franked distribution where the net income of the relevant trust (excluding franking credits) is less than the sum of the net capital gain of the trust and the total of all of the franked distributions (net of directly relevant deductions). This adjustment is necessary to ensure that beneficiaries and the trustee together are not assessed on more than the total taxable income of the trust. The adjustment will apply, for example, where a trust's only income is from capital gains and franked distributions and the trust has general management expenses. [*Schedule 2, item 19, subsections 207-37(2) and (3)*]

- *Specifically entitled to an amount of a franked distribution*

2.133 The concept of 'specific entitlement' is not the same as the concept of 'present entitlement'. This is discussed in detail in paragraphs 2.35 to 2.70.

2.134 The amount that a beneficiary is taken to be specifically entitled to in relation to a franked distribution is worked out in accordance with subsection 207-58(1). This subsection requires the beneficiary to multiply the amount of the franked distribution by the beneficiary's 'share of the net financial benefit' associated with the franked distribution divided by the total 'net financial benefit' associated with the distribution. [*Schedule 2, item 24, subsection 207-58(1)*]

2.135 Subsection 207-58(2) clarifies that the net financial benefit associated with a franked distribution is the financial benefit net of expenses that are directly relevant to the franked distribution. An example of such an expense is an interest outgoing incurred on borrowings taken out for the purpose of acquiring the share which gave rise to the franked distribution. [*Schedule 2, item 24, subsection 207-58(2)*]

2.136 A beneficiary of a trust that receives a franked distribution cannot generally be made specifically entitled to any share of that distribution if the whole of the distribution is sheltered at the trust level by directly relevant expenses. Moreover, despite being able

to be reduced by directly relevant expenses, a beneficiary's share of the net financial benefit referable to a franked distribution can never be less than nil.

Example 2.17

The Charlie Trust derives a distribution of \$100 and incurs directly related expenses of \$150. Under the deed of the trust, Mark is entitled to all of the dividend income of the trust.

Mark is not specifically entitled to any portion of the distribution as the distribution is entirely sheltered by directly related expenses at the trust level.

If instead the directly related expenses totalled only \$90, the effect of the deed is to make Mark presently entitled to the \$10 of trust income relating to the distribution. However for the purposes of section 207-58, Mark is specifically entitled to the whole of the distribution as his share of the net financial benefit associated with the distribution equals that total net financial benefit.

- **Trustee distributes all of the franked distributions within a single class*******

2.137 Where a trustee distributes all of the franked distributions received in an income year within a single class of income, Subdivision 207-B operates as if all of the franked distributions were 'pooled' into one single franked distribution. This allows trustees to 'stream' part or all of a class of income that includes franked distributions even where some of the individual franked distributions are entirely sheltered by directly relevant expenses.

2.138 The trustee does not need to distribute all of the class of income. However, for the 'pooling' to apply, every entitlement to part or all of a franked distribution must be an entitlement to part or all of the entire class of income. That is, if any part of even one franked distribution is 'streamed' separately from the class of income, the pooling does not apply to any franked distribution.

2.139 A *class of income* means an appropriate subset of trust income (and not all trust income generally) of which franked distributions are a generally accepted inclusion, such as 'franked dividends', 'dividends' or 'passive income'. Expenses that are directly relevant to all of the class of income may be charged against that class for trust purposes. However, for the purposes of determining specific entitlement, only the expenses directly relevant to the franked distributions will be taken into account (see paragraph 2.53).

[Schedule 2, item 24, section 207-59]

Example 2.18

The McLachlan Trust receives and then distributes in full four different franked distributions of \$70 and one unfranked distribution of \$100 in the 2010-11 income year. The trust incurs directly relevant expenses of \$100 in relation to one of the franked distributions. Under the terms of the trust Geoff is entitled to 50 per cent of the dividend income of the trust.

As the trust distributes the franked distributions within a single class (albeit a class that includes unfranked distributions), Geoff treats all of the franked distributions as one single franked distribution.

Therefore, he is specifically entitled to half of the (total) franked distributions of the trust (\$140 out of \$280) and will have an attributable franked distribution under section 207-37 of \$90 (\$280 - \$100/2). Geoff will also have a \$60 share of the \$120 of franking credits (including the franking credits on the franked distribution entirely sheltered by directly relevant expenses).

If instead Geoff was entitled to two of the four franked distributions, he could not be specifically entitled to the franked distribution entirely sheltered by the \$100 of directly relevant expenses (whether or not it was one of the two distributions to which he was

purportedly entitled). This is because the franked distributions of the trust would not have been distributed within a single class.

• ***Allocation of additional amounts of assessable income***

2.140 There are four conditions that must be satisfied before a portion of a franking credit is included in the assessable income of an entity for an income year:

- a franked distribution is made to or flows indirectly to a partnership or the trustee of a trust in an income year;
- the assessable income of the partnership or trust for that year includes an amount that is all or part of the franking credit;
- the distribution flows indirectly to an entity that is a partner in a partnership or a beneficiary of a trust or the trustee of that trust; and
- the entity has an amount of assessable income for that year that is attributable to all or part of the distribution.

2.141 Where these conditions are satisfied, an entity includes in its assessable income so much of the franking credit as is equal to its share of the franking credit on the franked distribution.

2.142 The existing subsection 207-35(3) is replaced by subsections 207-35(3) to (6) introduced by this Schedule. The effect of these amendments when read together with Division 6E is that:

- subsections 207-35(3) and (4) deal with the treatment of franking credits and franked distributions for the beneficiary of a trust; and
- subsections 207-35(5) and (6) deal separately with the treatment of franking credits and franked distributions for the trustee of a trust that, disregarding Division 6E, would be assessed and liable to tax under section 98, 99 or 99A.

2.143 In order to ensure the effective operation of section 207-35, the requirements in paragraphs 207-35(3)(d) and (5)(c) apply disregarding the operation of Division 6E. This is necessary to ensure that relevant entities have an amount of assessable income for the purposes of section 207-35. [*Schedule 2, item 18, paragraphs 207-35(3)(d) and 207-35(5)(c)*]

• ***Beneficiaries of a trust and partners in a partnership***

2.144 Subsection 207-35(3) now only lists the four requirements that must be met before subsection 207-35(4) operates to include an amount in the assessable income of either a partner in a partnership or the beneficiary of a trust. [*Schedule 2, item 18, subsection 207-35(3)*]

2.145 Where an entity is a partner in a partnership and the conditions outlined in subsection 207-35(3) are satisfied, paragraph 207-35(4)(a) includes, in the partner's assessable income, so much of the franking credit as is equal to the partner's share of the franking credit on the franked distribution. This is consistent with the existing law. [*Schedule 2, item 18, paragraph 207-35(4)(a)*]

2.146 Where the entity is the beneficiary of a trust, subparagraph 207-35(4)(b)(i) includes in the beneficiary's assessable income so much of its share of the franking credit on the distribution. This is also broadly consistent with the current law.

2.147 However, in contrast to the existing law, subparagraph 207-35(4)(b)(ii) also requires the beneficiary to include in its assessable income, its attributable franked distribution as calculated in accordance with section 207-37 (see paragraph 2.121). [*Schedule 2, item 18, paragraph 207-35(4)(b)*]

Example 2.19

A fully franked distribution of \$70 is made to the trustee of the Sloper Trust in the 2010-11 income year. The trust also has \$100 of rental income for the income year. The income of the trust estate is \$170. The taxable income of the trust is \$200 (including the \$30 franking credit attached to the distribution).

The trust has two beneficiaries, Phillip and Katie, each presently entitled to 50 per cent of the income of the trust estate. Neither beneficiary is specifically entitled to any particular class of income. Therefore, each uses the same methodology in working out their share of the franked distribution and franking credits.

Because no beneficiary has a specific entitlement to the franked distribution, their share of that franked distribution will be determined by reference to their adjusted Division 6 percentage. Phillip and Katie are each entitled to 50 per cent of the income of the trust estate (and no adjustments are required as there are no capital gains or franked distributions to which someone is specifically entitled). Accordingly, each has a share of the franked distribution of \$35 ($\70×50 per cent), and an attributable distribution of the same amount ($\$70 \times \$35/\$70$) (see paragraph 2.121).

As worked out under section 207-57, their share of the franking credit on the franked distribution is the franking credit, multiplied by their percentage share of the franked distribution ($\$30 \times \$35/\$70$), or \$15.

Phillip and Katie therefore each include \$35 of the franked distribution and \$15 of the franking credit in their assessable income under Subdivision 207-B (a total of \$50).

As a result of Division 6E, the amount otherwise assessed under Division 6 is reduced by the \$100 brought to tax under Subdivision 207-B. Specifically, the amount assessed to Phillip and Katie under Division 6 is calculated as if:

- the \$70 dividend and \$30 associated franking credit was disregarded for the purposes of calculating the trust's taxable income;
- the \$70 franked distribution were disregarded for the purposes of calculating the income of the trust estate; and
- Phillip's and Katie's present entitlement excluded their \$35 share of the franked distribution.

As such, section 97 of the ITAA 1936 includes \$50 ($(\$85 - \$35) / (\$170 - \$70) \times (\$200 - \$100)$) in both of Phillip's and Katie's assessable income instead of \$100 as would otherwise have been the case.

The total amount included in each of their assessable income is \$100 (\$50 under Subdivision 207-B and \$50 under section 97 of the ITAA 1936).

• Trustees

2.148 These amendments deal separately with the case where, disregarding Division 6E, a trustee is assessed and liable to pay tax under section 98, 99 or 99A of the ITAA 1936. Subsection 207-35(5) now lists the requirements that must be met before subsection 207-35(6) operates to make a trustee liable to be assessed (and pay tax). *[Schedule 2, item 18, subsections 207-35(5) and (6)]*

2.149 If the conditions in subsection 207-35(5) are satisfied a trustee is required to increase the amount on which it is assessed under Division 6 so as to bring to tax in the trustee's hands an appropriate share of the distribution (also calculated in accordance with section 207-37 and referred to as the attributable franked distribution) and an appropriate share of the franking credit. *[Schedule 2, item 18, subsection 207-35(6)]*

Example 2.20

A fully franked distribution of \$70 is paid to the trustee of the Marsden Trust in the 2010-11 income year. The trust also has \$300 of interest income for the income year. The income of the trust estate is \$370. The taxable income of the trust is \$400 (including the \$30 franking credit attached to the distribution).

The trust has two beneficiaries, Huy and Andrew. Andrew is under a legal disability.

Huy is presently entitled to 50 per cent of the income of the trust estate and Andrew is presently entitled to 40 per cent of the income of the trust estate. Neither Huy nor Andrew is specifically entitled to any particular class of income. No beneficiary is presently entitled to the remaining 10 per cent of the income of the trust estate.

Because no beneficiary has a specific entitlement to the franked distribution, each beneficiary's share of the \$70 franked distribution will be determined by reference to their adjusted Division 6 percentage. Huy is entitled to 50 per cent and Andrew to 40 per cent of the income of the trust estate (and no adjustments are required as there are no capital gains or franked distributions to which someone is specifically entitled).

Accordingly, Huy has a share of the franked distribution of \$35 ($\70×50 per cent), and an attributable distribution of the same amount ($\$70 \times \$35/\$70$) (see paragraph 2.121).

Under section 207-57 he also has a share of the franking credit of \$15 ($\$30 \times \$35/\70).

Huy includes \$35 of the franked distribution and \$15 of the franking credits in his assessable income under Subdivision 207-B.

Under Division 6E, the amount assessed to the beneficiaries and trustee under Division 6 is calculated as if the \$70 dividend and \$30 associated franking credit were disregarded for the purposes of calculating the trust's taxable income, the \$70 franked distribution was disregarded for the purposes of calculating the income of the trust estate, and the beneficiaries' present entitlements exclude their share of the franked distribution. As such, section 97 of the ITAA 1936 includes in Huy's assessable income \$150 ($(\$185 - \$35)/(\$370 - \$70) \times (\$400 - \$100)$) instead of \$200 as would otherwise have been the case.

The total amount included in his assessable income is \$200 (\$50 under Subdivision 207-B — including \$15 of franking credits — and \$150 under section 97 of the ITAA 1936).

As Andrew is under a legal disability, the trustee of the trust is assessed and liable to tax under subsection 98(1) in respect of Andrew on a total of \$160 (including \$40 calculated in respect of Andrew's share of the franked distribution and franking credit — comprising a \$28 share of the distribution and a \$12 share of the franking credit — as a result of subsection 207-35(6)).

The trustee is also assessed and liable to tax on the remaining \$40 of the taxable income of the trust under section 99A (including \$10 in respect of its own share of the franked distribution and franking credit — comprising a \$7 share of the distribution and a \$3 share of the franking credit — as a result of subsection 207-35(6)).

- **Application of new Division 6E to adjust Division 6 assessable amounts**

2.150 Where necessary, Division 6E adjusts the amount otherwise included in a beneficiary's assessable income (or assessed to the trustee) under Division 6 by effectively ignoring any capital gains and franked distributions of the trust. These amounts are brought to tax under Subdivision 115-C and 207-B respectively.

2.151 The sole effect of Division 6E is to adjust the amount included in a beneficiary's assessable income or assessed to the trustee under Division 6 — it does not adjust the 'income of the trust estate', 'net income of the trust' or a beneficiary's present entitlement to trust income for any other purpose. For example, Division 6E does not modify the operation of Division 6 for the purposes of applying section 100A of the ITAA 1936.

2.152 Division 6E does not 'unwind' any increase in a trustee's liability under section 98, 99 or 99A of the ITAA 1936 arising from Subdivisions 115-C and 207-B. In

other words, an increase in the trustee's liability under Subdivision 115-C and 207-B happens *after* any modification by Division 6E.

2.153 **The primary purpose of Division 6E is to avoid double taxation on capital gains and franked distributions.** Division 6E also ensures that Division 6 continues to correctly assess a presently entitled beneficiary on their share of the taxable income of the trust where they are presently entitled to income *other* than capital gains and franked distributions.

2.154 In most instances, adjustments made under Division 6E result in a reduction of the amount otherwise assessable under Division 6. However, these adjustments can also result in an increase in the amount otherwise assessable to a taxpayer in some circumstances. (see paragraphs 2.162 to 2.164).

• **When Division 6E applies**

2.155 Division 6E applies where:

- the trust has a positive taxable income; and
- capital gains (after applying capital losses and any CGT concessions), 'net' franked distributions and/or franking credits are taken into account in working out that taxable income.

[Schedule 2, item 7, section 102UW of the ITAA 1936]

2.156 To work out amounts assessable to a beneficiary (under section 97, 98A or 100), a trustee in respect of a beneficiary (under section 98) and a trustee under section 99 or 99A, Division 6E requires the trustee to assume that the:

- 'income of the trust estate' instead equals the 'Division 6E income of the trust estate';
- 'net income of the trust estate' instead equals the 'Division 6E net income of the trust estate'; and
- amount of a beneficiary's present entitlement to the income of the trust estate instead equals the amount of the beneficiary's 'Division 6E present entitlement to the (Division 6E) income of the trust estate'.

[Schedule 2, item 7, sections 102UX and 102UY of the ITAA 1936]

• **Division 6E income of the trust estate**

2.157 The **Division 6E income** of the trust estate is the income of the trust estate worked out on the assumption that it does not include any amounts 'attributable' to capital gains (after capital losses and any CGT concessions), 'net' franked distributions or franking credits. *The amount cannot be less than nil, even where the amounts attributable to capital gains, 'net' franked distributions and franking credits exceed the income of the trust estate.* *[Schedule 2, item 7, subsection 102UY(2) of the ITAA 1936]*

Example 2.21

The McGovern Trust has income of the trust estate of \$120, calculated as \$100 of rental income plus \$70 of franked distributions less \$50 of directly related deductible expenses. The trust's 'Division 6E income of the trust estate' is \$100 — that is, the income of the trust estate disregarding the \$20 attributable to the net franked distribution.

2.158 The amounts 'attributable' to a capital gain, franked distribution or franking credit may not neatly align with the components of the 'income of the trust estate' calculated for trust purposes. However, an amount of trust income is generally 'attributable' to a capital gain or net franked distribution where it corresponds to tax amounts of these items of income.

- For example, an amount attributable to a capital gain is generally the amount of net financial benefit arising from the same CGT event that gave rise to the capital gain for taxation purposes.
- Similarly for franked distributions, the amount attributable generally corresponds to the amount of the ‘net’ franked distribution that is taken into account in working out the taxable income of the trust.

Example 2.22

The Coffee Trust has income of \$470,000, made up of \$100,000 rental income, a \$70,000 franked distribution and a \$300,000 capital gain (for trust purposes).

The trust’s taxable income is \$300,000, calculated as \$100,000 rental income, \$70,000 franked distribution plus \$30,000 attached franking credits and a net capital gain of \$100,000 (being the \$300,000 capital gain reduced by a prior year net capital loss of \$100,000 and the general CGT 50 per cent discount).

Division 6E applies to the trust as it has positive taxable income and (part of) the capital gain, franked distribution and franking credits were taken into account in working out that taxable income. Accordingly, for the purpose of calculating amounts assessed under Division 6, the trustee assumes that the income of the trust estate instead equals the ‘Division 6E income of the trust estate’.

The Division 6E income of the trust estate is \$100,000, calculated as \$470,000 less \$70,000 (the franked distribution) and less \$300,000 (the trust capital gain). (The full trust capital gain is taken out of the calculation because the prior year net capital loss was not chargeable against the income of the trust in the first place.)

• Division 6E net income of the trust estate

2.159 The *Division 6E net income* of the trust estate is the ‘net income of the trust estate’ worked out on the assumption that any capital gain (after any capital losses and CGT discounts are applied), ‘net’ franked distribution and franking credits were not taken into account in working out the net income. As with the ‘Division 6E income of the trust estate’, the amount cannot be less than nil. [*Schedule 2, item 7, subsection 102UY(3) of the ITAA 1936*]

Example 2.23

Continuing from Example 2.22, the Coffee Trust’s ‘Division 6E net income’ is \$100,000. This is worked out as the trust’s taxable income of \$300,000 reduced by the \$100,000 (the sum of the franked distribution and attached franking credits) and \$100,000 (the capital gain remaining after losses and discounts are applied).

• Division 6E present entitlement to the income of the trust estate

2.160 A beneficiary’s *Division 6E present entitlement to the income of the trust estate* is effectively the amount of ‘Division 6E income of the trust estate’ to which the beneficiary is presently entitled — that is, excluding amounts attributable to capital gains and franked distributions from both the entitlements and the income of the trust estate.

2.161 This present entitlement is worked out as the amount of the beneficiary’s present entitlement to the income of the trust estate worked out under Division 6 (without modification), decreased by:

- for each capital gain taken into account in working out the taxable income of the trust:
 - the beneficiary’s share of the capital gain as determined under Subdivision 115-C, to the extent that it was included in the income of the trust estate; and
- for each franked distribution taken into account in working out the taxable income of the trust:

- the beneficiary’s share of the franked distribution as determined under Subdivision 207-B to the extent that it was included in the income of the trust estate.

[Schedule 2, item 7, subsection 102UY(4) of the ITAA 1936]

Example 2.24*****

Continuing from Example 2.23, and suppose at the end of the income year the trustee resolves to distribute amounts as follows:

- **to Anthea: all of the rental income (\$100,000);**
- **to Cameron: all of the franked distribution (\$70,000); and**
- **to Graeme: all of the capital gain (\$300,000).**

Anthea’s Division 6E present entitlement to the Division 6E income of the trust is \$100,000 (no part of her present entitlement is attributable to capital gains or franked distributions). The amount she is assessed on under section 97 of the ITAA 1936 is therefore \$100,000 (as she has a 100 per cent share of the Division 6E income and therefore is assessed on 100 per cent of the Division 6E net income).

Cameron’s Division 6E present entitlement to the Division 6E income of the trust is \$0 (after disregarding the franked distribution). The amount he is assessed on under Division 6 as modified by Division 6E is therefore \$0. (He will be assessed on the franked distribution and attached franking credits under Subdivision 207-B.)

Graeme also has a Division 6E present entitlement of \$0 (after disregarding the capital gain). The amount he is assessed on under Division 6 as modified by Division 6E is also \$0. (He will be treated as having an extra capital gain under Subdivision 115-C.)

• Division 6E may increase a taxpayer’s Division 6 assessable amount

2.162 As noted above, in some circumstances Division 6E increases the amount that Division 6 includes in a taxpayer’s assessable income.

2.163 This can only occur for a beneficiary (or trustee) when:

- another entity is specifically entitled to an amount of capital gains or (net) franked distributions of a trust that is included in the ‘income of the trust estate’; and
- for all of the other income of the trust, the ‘taxable income’ exceeds the ‘income of the trust estate’.

2.164 An increase in the amount assessed to one taxpayer will reflect a corresponding decrease in the amount assessed to another. This is necessary to ensure that:

- when a beneficiary is specifically entitled to an amount of a capital gain or (net) franked distribution, they are only taxed by reference to that amount (unless they are also presently entitled to other trust income); and
- all of the taxable income of the trust is brought to tax.

Example 2.25

Aaron is entitled to all of the capital gains of a trust, and Bennett is entitled to all of the other income of the trust. The trust deed defines ‘income’ to include capital gains.

In the 2011-12 income year, the trustee of the trust made a \$100 capital gain (no CGT concessions applied). The trustee also had \$100 of other income for trust purposes. However, due to a timing difference, the amount of other income assessable for tax purposes is instead \$900.

Under the ordinary operation of Division 6, the income of the trust estate is \$200 and the taxable income is \$1,000. As Aaron and Bennett are each entitled to 50 per cent of the ‘income of the trust estate’, they would each be assessed on \$500 under section 97 of the ITAA 1936.

However, Division 6E applies to adjust the amounts that would otherwise be included in Aaron and Bennett’s assessable incomes by effectively ignoring the capital gain.

- The Division 6E income of the trust is \$100 under subsection 102UY(2).
- The Division 6E net income of the trust is \$900 under subsection 102UY(3).
- Bennett is presently entitled to all of the Division 6E income of the trust (\$100) under subsection 102UY(4).

The following table compares each beneficiary’s original and adjusted section 97 amount. There is no trustee assessment.

• <i>Beneficiary</i>	• <i>Original section 97 amount</i>	• <i>Adjusted section 97 amount (section 94ZC)</i>
Aaron	\$500	\$0
Bennett	\$500	\$900

The increase in Bennett’s assessable income corresponds to the decrease in Aaron’s assessable income. (Subdivision 115-C applies to treat Aaron as having an extra capital gain of \$100 as he is specifically entitled to the entire gain.)

• **Combined operation of the streaming provisions**

2.165 As noted earlier, Division 6 is the starting point for the taxation of trust income. However, the amounts assessable to beneficiaries (or the trustee) may be modified by the rules in Division 6E.

2.166 Then, where a trustee makes capital gains and derives franked distributions, Subdivisions 115-C and 207-B both apply and operate simultaneously and independently.

2.167 Although the two Subdivisions apply independently, they can interact when a trust has both capital gains and franked distributions. In particular, each Subdivision depends on:

- the sum of capital gains made by the trustee, and the net capital gain of the trust;
- the sum of franked distributions derived by the trustee (net of directly relevant deductions); and
- the beneficiaries’ (and trustee’s) ‘adjusted Division 6 percentage’.
 - This share depends on the extent to which beneficiaries are specifically entitled to capital gains *and* franked distributions.

2.168 The following examples provide detailed, step-by-step calculations of amounts assessable to beneficiaries (and the trustee if relevant) under Division 6 (as adjusted by Division 6E) and Subdivisions 115-C and 207-B.

2.169 Each example uses the same general facts (see Example 2.26). The examples differ primarily in the way ‘income’ is defined in the trust deed.

- In the first example, the trust deed does not define income and therefore takes its ordinary meaning — in particular it does not include capital gains (see Example 2.27).
 - The second example continues the first example, but assumes carry-forward tax losses to demonstrate how taxable amounts relating to capital gains and franked distributions may be rateably reduced (see Example 2.28).
- In the third example the trust deed defines the income of the trust to include ordinary income plus net capital gains (see Example 2.29).
- In the fourth example the trust deed defines the income of the trust to include ordinary income plus capital gains according to accounting concepts (see Example 2.30).

Example 2.26

A trust has four beneficiaries: Ash, Bradshaw, Claire and Dawson.

In the 2010-11 income year, the trust derived the following amounts.

- Net rental income of \$100,000.
- A first franked distribution of \$70,000 (with \$30,000 franking credits attached), with \$50,000 of directly related deductible expenses.
- A second franked distribution of \$70,000 (with \$30,000 franking credits attached), with no directly related deductible expenses.
- A capital gain of \$200,000 that is eligible for the CGT discount.
- A capital gain of \$100,000 that is not eligible for the CGT discount.

The trust had a (prior year) net capital loss of \$50,000 carried forward into the 2010-11 income year.

The trustee chooses to apply the net capital loss against the \$100,000 capital gain that is not eligible for the discount.

The section 95 net income of the trust is therefore \$400,000 —calculated as \$100,000 net rental income + \$90,000 net franked distributions + \$60,000 franking credits + \$150,000 net capital gain.

The Division 6E net income of the trust is \$100,000 (the net rental income) disregarding all of the taxable income attributable to the capital gains, franked distributions and franking credits (subsection 102UY(3) of the ITAA 1936).

Example 2.27

Using the general facts in Example 2.26, and assume the trust deed does not define 'income', which therefore takes its ordinary meaning — that is, it does not include capital gains made by the trust. The trust's distributable income is therefore \$190,000 (\$100,000 of net rental income plus (\$140,000 – \$50,000) of 'net' franked distributions).

In accordance with a power under the deed, the trustee resolves to make income and capital distributions in the following amounts.

- To Ash \$50,000 of 'income' and a \$100,000 capital distribution that is specified to be attributable to the discount capital gain.
- To Bradshaw: a \$50,000 capital distribution specified to be attributable to the non-discount capital gain (the other \$50,000 is retained to replenish the trust corpus for the prior year capital loss).
- To Claire: \$20,000 of income specified to be wholly attributable to the first (net) franked distribution.

- To Dawson: the balance of distributable income. (She is therefore entitled to \$120,000 (\$190,000 – \$50,000 – \$20,000).)

Step 1 — Apply Division 6 unmodified by Division 6E

The following table summarises the respective shares of the trust income and taxable income of each beneficiary under Division 6 (ignoring the effect of Division 6E).

• Beneficiary	• Present entitlement	• Division 6 percentage	• Section 97 share of net income
Ash	\$50,000	26.3% (\$50,000/\$190,000)	\$105,263
Bradshaw	\$0	0% (\$0/\$190,000)	\$0
Claire	\$20,000	10.5% (\$20,000/\$190,000)	\$42,105
Dawson	\$120,000	63.2% (\$120,000/\$190,000)	\$252,632
Total	\$190,000	100%	\$400,000

Step 2 — calculate beneficiaries' adjusted Division 6 percentage

Before applying Subdivisions 115-C and 207-B, it is convenient to calculate 'adjusted Division 6 percentages' for beneficiaries.

As a result of the distributions, Ash is specifically entitled to 50 per cent of the discount capital gain. Bradshaw is specifically entitled to all of the non-discount capital gain. Claire is specifically entitled to all of the first (net) franked distribution.

There is \$100,000 of the discount capital gain and a \$70,000 franked distribution (with a \$30,000 franking credit attached) to which no beneficiary is specifically entitled. However, only the franked distribution is included in the income of the trust.

Excluding amounts to which beneficiaries are specifically entitled, the 'adjusted income' of the trust is \$170,000 (\$100,000 net rental income plus the second \$70,000 franked distribution). Each beneficiary's adjusted Division 6 percentage of that 'adjusted income' is as follows.

• Beneficiary	• Present entitlement to 'adjusted income'	• Share of 'adjusted income'
Ash	\$50,000	29.4%
Bradshaw	\$0	0%
Claire	\$0	0%
Dawson	\$120,000	70.6%
Total	\$170,000	100%

Step 3 — apply Subdivision 115-C

Applying Subdivision 115-C, capital gains are allocated to a beneficiary based on their specific entitlement and adjusted Division 6 percentage (from step 2). (All columns relate to the \$200,000 discount capital gain except Bradshaw's, which relates to the \$100,000 gain).

• Concept/ provision	• A s h	• B r a d s h a w	• C l a i r e	• D a w s o n
Specific entitlement 115-227(a)	\$100,000	\$100,000	N/A	\$0
Adjusted Division 6 percentage share 115-227(b)	\$29,400	\$0	N/A	\$70,600
Share of capital gain (amount) 115-227	\$129,400	\$100,000	N/A	\$70,600
(Total) capital gain	\$200,000	\$100,000	N/A	\$200,000
Fraction of the gain 115-225(1)(b)	64.7%	100%	N/A	35.3%
Tax related to gain 115-225(1)(a)	\$100,000	\$50,000	N/A	\$100,000
Attributable gain 115-225(1)	\$64,700	\$50,000	N/A	\$35,300
Gross up? 115-215(3)	Yes	No	N/A	Yes
Extra capital gain 115-215(3)	\$129,400	\$50,000	N/A	\$70,600

Note that Bradshaw is specifically entitled to all of the (gross) capital gain of \$100,000 because he received all of the net financial benefit relating to the gain after the trustee applied losses for trust purposes in a way consistent with the application of capital losses for tax purposes.

Ash, Bradshaw and Dawson can then apply any capital losses or net capital loss they have to reduce these extra capital gains. Since the extra capital gain made by Ash and Dawson was made in respect of a discount capital gain of the trust and they are individuals, they would be able to apply the CGT discount to any amount remaining (see existing paragraph 115-215(4)(a)).

Step 4 — apply Subdivision 207-B

Applying Subdivision 207-B, franked distributions are allocated to a beneficiary based on their specific entitlement and adjusted Division 6 percentage. (All columns relate to the \$70,000 franked distribution except Claire's, which relates to the \$20,000 net franked distribution.)

• Concept /provision	• Ash	• Bradshaw	• Claire	• Dawson
Specific entitlement 207-55(4)(a)	\$0	N/A	\$70,000	\$0
Adjusted Division 6 percentage share 207-55(4)(b)	\$20,580	N/A	\$0	\$49,420
Share of franked distribution (amount) 207-55 (via table)	\$20,580	N/A	\$70,000	\$49,420
Fraction of the distribution 207-37(1)(b)	29.4%	N/A	100%	70.6%
Tax related to distribution 207-37(1)(a)	\$70,000	N/A	\$20,000	\$70,000
Franking credit 207-35(4)(b)(i)	\$8,820	N/A	\$30,000	\$21,180
Attributable franked distribution 207-35(4)(b)(ii)	\$20,580	N/A	\$20,000	\$49,420

Each beneficiary is assessed on their attributable franked distribution and their share of the franking credits under paragraph 207-35(4)(b).

Step 5 — recalculate assessable amounts using Division 6E

The beneficiaries' assessable amounts under section 97 of the ITAA 1936 are adjusted by the operation of Division 6E, based on the amounts calculated under section 102UY of the ITAA 1936.

- The Division 6E income of the trust estate is \$100,000, because the \$90,000 attributable to the franked distributions is disregarded.
- The Division 6E net income is also \$100,000 (from the general facts set out in Example 2.26).
- Ash's Division 6E present entitlement is \$29,420 (calculated under subsection 102UY(4) of the ITAA 1936 as his present entitlement to trust income of \$50,000 minus his share of franked distributions of \$20,580 — note that his share of the capital gain of the trust is not part of trust income).
- Bradshaw and Claire have no Division 6E present entitlement as their only entitlements were to capital gains and franked distributions respectively.
- Dawson's Division 6E present entitlement is \$70,580 (calculated under subsection 102UY(4) of the ITAA 1936 as her present entitlement to trust income of \$120,000 minus her share of franked distributions of \$49,420).

The modified amounts assessable under Division 6 are as follows:

• Beneficiary	• Division 6E present entitlement	• Share of Division 6E income	• Section 97 assessable amount
Ash	\$29,420	29.4% ($\$29,420/\$100,000$)	\$29,420
Bradshaw	\$0	0%	\$0
Claire	\$0	0%	\$0
Dawson	\$70,580	70.6% ($\$70,580/\$100,000$)	\$70,580

Step 6 — overall result

The following table sets out for each beneficiary the overall tax treatment of the amounts they received from the trust. (It assumes for convenience that beneficiaries had no other capital gains and no capital losses or net capital loss, and are eligible for the franking credits.)

• Concept/provision	• Ash	• Bradshaw	• Claire	• Dawson	• Total
Adjusted section 97 assessable amount	\$29,420	\$0	\$0	\$70,580	\$100,000
Net capital gain 102-5	\$64,700	\$50,000	\$0	\$35,300	\$150,000
Attributable franked distribution 207-37(1)(a)	\$20,580	\$0	\$20,000	\$49,420	\$90,000
Franking credit 207-35(4)(b)(i)	\$8,820	\$0	\$30,000	\$21,180	\$60,000
Total assessable income	\$123,520	\$50,000	\$50,000	\$176,480	\$400,000
Amount received from the trust	\$150,000	\$50,000	\$20,000	\$120,000	\$340,000

Note that the total assessable income equals the net income of the trust. The total amounts received from the trust equals the trust income of \$190,000 plus \$150,000 of capital distributions to Ash and Bradshaw.

Example 2.28

Following on from Example 2.27, suppose that the trust had carry forward tax losses of \$280,000. The taxable income of the trust is therefore \$120,000 (\$400,000 –

\$280,000). (The trust income does not change and assume that the trustee's resolutions also do not change.)

The sum of the net capital gain and (net) franked distributions is \$240,000. As this exceeds the net income of the trust (excluding franking credits) of \$60,000, the taxable income of the trust attributable to each capital gain and franked distribution is reduced by three quarters ($\$60,000/\$240,000$) because of subsections 115-225(2) and (3) and subsections 207-37(2) and (3).

Therefore:

- Ash reduces his extra capital gain to \$32,350 ($\$129,400/4$) and his assessable franked distribution to \$5,145 ($\$20,580/4$).
- Bradshaw reduces his extra capital gain to \$12,500 ($\$50,000/4$).
- Claire reduces her attributable franked distribution to \$5,000 ($\$20,000/4$).
- Dawson reduces her extra capital gain to \$17,650 ($\$70,600/4$) and his attributable franked distribution to \$12,355 ($\$49,420/4$).

Note that this rateable reduction does not reduce the franking credits attached to the franked distributions.

Applying Division 6E, the 'Division 6E net income of the trust' disregarding net capital gains and net franked distributions is \$0. Therefore, regardless of beneficiaries' Division 6E present entitlement, their adjusted section 97 assessable income is \$0.

The following table sets out each beneficiary's overall tax treatment after taking into account the carry-forward tax loss.

<i>• Concept /provision</i>	<i>•</i>	<i>• Bradshaw</i>	<i>•</i>	<i>•</i>	<i>•</i>
Adjusted section 97 assessable amount	\$0	\$0	\$0	\$0	\$0
Net capital gain 102-5	\$16,175	\$12,500	\$0	\$8,825	\$37,500
Attributable franked distribution 207-37(1)(a)	\$5,145	\$0	\$5,000	\$12,355	\$22,500
Franking credit 207-35(4)(b)(i)	\$8,820	\$0	\$30,000	\$21,180	\$60,000
Total assessable income	\$30,140	\$12,500	\$35,000	\$42,360	\$120,000

Note again that total assessable income equals the taxable income of the trust after taking into account the carry-forward tax loss.

Example 2.29

Using the general facts in Example 2.26, and assume that the trust deed defines 'income' to include the net capital gains of the trust (as defined in the ITAA 1997). The trust's distributable income is therefore \$340,000 (\$100,000 of net rental income, \$90,000 of 'net' franked distributions and \$150,000 net capital gains).

In accordance with a power under the deed, the trustee resolves to make income distributions in the following amounts.

- To Ash: \$150,000 of income, of which \$100,000 is purported to be attributable to the taxable part of the discount capital gain.
- To Bradshaw: \$50,000 of income specified to be attributable to the non-discount capital gain (the other \$50,000 is retained to replenish the corpus for a prior year capital loss).
- To Claire: \$20,000 of income specified to be wholly attributable to the first (net) franked distribution.
- To Dawson: the balance of distributable income. (She is therefore entitled to \$120,000 (\$340,000 – \$150,000 – \$50,000 – \$20,000).)

Step 1 — apply Division 6 unmodified by Division 6E

The following table summarises the respective shares of the trust income and taxable income of each beneficiary under Division 6 (ignoring the effect of Division 6E).

• B e n e f i c i a r y	• Pres ent entit leme nt	• Division 6 percentage	• Sectio n 97 share of net incom e
Ash	\$150,000	44.1% (\$150,000/\$340,000)	\$176,471
Bradshaw	\$50,000	14.7% (\$50,000/\$340,000)	\$58,824
Claire	\$20,000	5.9% (\$20,000/\$340,000)	\$23,529
Dawson	\$120,000	35.3% (\$120,000/\$340,000)	\$141,176
Total	\$340,000	100%	\$400,000

Step 2 — calculate beneficiaries’ adjusted Division 6 percentage

Although the trustee purported to make Ash specifically entitled to all of the taxable part of the discount capital gain, he only received half of the net economic benefit referable to the capital gain. He is therefore only specifically entitled to half of the \$200,000 capital gain.

Further, because the trust income includes *net* capital gains, only half of Ash’s specific entitlement to the discount capital gain was included in the trust income.

The ‘adjusted income of the trust estate’ is \$220,000 — that is, the trust income of \$340,000 less \$50,000 of Ash’s entitlement and less Bradshaw’s \$50,000 entitlement (since, in both cases, only half of the capital gain was included in trust income), and less Claire’s \$20,000.

Ash’s present entitlement to ‘adjusted income’ is \$100,000 (because only \$50,000 of his specific entitlement was part of trust income and therefore disregarded). Dawson’s present entitlement to the ‘adjusted income’ is \$120,000.

Each beneficiary’s share of that ‘adjusted income’ is as follows.

• Beneficiary	• Present entitlement to 'adjusted income'	• Share of 'adjusted income'
Ash	\$100,000	45.5%
Bradshaw	\$0	0%
Claire	\$0	0%
Dawson	\$120,000	54.5%
Total	\$220,000	100%

Step 3 — apply Subdivision 115-C

Applying Subdivision 115-C, capital gains are allocated to a beneficiary based on their specific entitlement and adjusted Division 6 percentage (from step 2). (All columns relate to the \$200,000 capital gain except Bradshaw's, which relates to the \$100,000 gain.)

• Concept/ provision	• A s h	• B r a d s h a w	• C l a i r e	• D a w s o n
Specific entitlement 115-227(a)	\$100,000	\$100,000	N/A	\$0
Adjusted Division 6 percentage share 115-227(b)	\$45,500	\$0	N/A	\$54,500
Share of capital gain (amount) 115-227	\$145,500	\$100,000	N/A	\$54,500
(Total) capital gain	\$200,000	\$100,000	N/A	\$200,000
Fraction of the gain 115-225(1)(b)	72.8%	100%	N/A	27.3%
Tax related to gain 115-225(1)(a)	\$100,000	\$50,000	N/A	\$100,000
Attributable gain 115-225(1)	\$72,750	\$50,000	N/A	\$27,250
Gross up 115-215(3)	Yes	No	N/A	Yes
Extra capital gain 115-215(3)	\$145,500	\$50,000	N/A	\$54,500

Step 4 — apply Subdivision 207-B

Applying Subdivision 207-B, franked distributions are allocated to a beneficiary based on their specific entitlement and adjusted Division 6 percentage. (All columns relate to the \$70,000 franked distribution except Claire's, which relates to the \$20,000 net franked distribution.)

• Concept /provision	• Ash	• Dawson	• Claire	• Dawn
Specific entitlement 207-55(4)(a)	\$0	N/A	\$70,000	\$0
Adjusted Division 6 percentage share 207-55(4)(b)	\$31,850	N/A	\$0	\$38,150
Share of franked distribution (amount) 207-55 (via table)	\$31,850	N/A	\$70,000	\$38,150
Fraction of the distribution 207-37(1)(b)	45.5%	N/A	100%	54.5%
Tax related to distribution 207-37(1)(a)	\$70,000	N/A	\$20,000	\$70,000
Franking credit 207-35(4)(b)(i)	\$13,650	N/A	\$30,000	\$16,350
Attributable franked distribution 207-35(4)(b)(ii)	\$31,850	N/A	\$20,000	\$38,150

Step 5 — recalculate assessable amounts using Division 6E

The beneficiaries' assessable amounts under section 97 of the ITAA 1936 are adjusted by the operation of Division 6E, based on the amounts calculated under section 102UY of the ITAA 1936.

- The Division 6E income of the trust estate is still \$100,000, because the \$150,000 attributable to the capital gains and the \$90,000 attributable to the franked distributions are disregarded. The Division 6E net income is also still \$100,000.
- Ash's Division 6E present entitlement is \$45,400 — calculated under subsection 102UY(4) of the ITAA 1936 as his present entitlement to trust income of \$150,000 minus his \$31,850 share of franked distributions and minus \$72,750 (since only half of his \$145,500 share of the capital gain is included in trust income).
- Dawson's Division 6E present entitlement is \$54,600 — calculated under subsection 102UY(4) of the ITAA 1936 as her present entitlement to trust income of \$120,000 minus her \$38,150 share of franked distributions and minus \$27,250 (since only half of her share of the capital gain is included in trust income).

The modified amounts assessable under Division 6 are as follows.

• Beneficiary	• Division 6E present entitlement	• Share of Division 6E income	• Section 97 assessable amount
Ash	\$45,400	45.4% (\$45,400/\$100,000)	\$45,400
Bradshaw	\$0	0%	\$0
Claire	\$0	0%	\$0
Dawson	\$54,600	54.6% (\$54,600/\$100,000)	\$54,600

Step 6 — overall result

The following table sets out for each beneficiary the overall tax treatment of the amounts they received from the trust. (It assumes for convenience that beneficiaries had no other capital gains and no capital losses or net capital loss, and are eligible for the franking credits.)

• Concept/provision	• Ash	• Bradshaw	• Claire	• Dawson	• Total
Adjusted section 97 assessable amount	\$45,400	\$0	\$0	\$54,600	\$100,000
Net capital gain Section 102-5	\$72,750	\$50,000	\$0	\$27,250	\$150,000
Attributable franked distribution 207-37(1)(a)	\$31,850	\$0	\$20,000	\$38,150	\$90,000
Franking credit 207-35(4)(b)(i)	\$13,650	\$0	\$30,000	\$16,350	\$60,000
Total assessable income	\$163,650	\$50,000	\$50,000	\$136,350	\$400,000
Amount received from the trust	\$150,000	\$50,000	\$20,000	\$120,000	\$340,000

Example 2.30

Using the general facts in Example 2.26, and assuming the trust deed defines ‘income’ to include gross capital gains made by the trust.

The trust’s distributable income is therefore \$490,000 (\$100,000 of net rental income plus \$90,000 of ‘net’ franked distributions plus \$300,000 of gross capital gains). Note that the trustee has not applied losses against any of the trust capital gains in determining the trust income.

In accordance with a power under the deed, the trustee resolves to make income distributions in the following amounts.

- To Ash: \$150,000 of ‘income’, of which \$100,000 is specified to be attributable to the discount capital gain.
- To Bradshaw: \$50,000 of income specified to be attributable to the non-discount capital gain.
- To Claire: \$20,000 of income specified to be wholly attributable to the first (net) franked distribution.
- To Dawson: the balance of distributable income. (She is therefore entitled to \$270,000 (\$490,000 – \$150,000 – \$50,000 – \$20,000).)

Step 1 — apply Division 6 unmodified by Division 6E

The following table summarises the respective shares of the trust income and taxable income of each beneficiary under Division 6 (ignoring the effect of Division 6E).

<i>• Beneficiary</i>	<i>• Present entitlement</i>	<i>• Division 6 percentage</i>	<i>• Section 97 share of net income</i>
Ash	\$150,000	30.6% (\$150,000/\$490,000)	\$122,449
Bradshaw	\$50,000	10.2% (\$50,000/\$490,000)	\$40,816
Claire	\$20,000	4.1% (\$20,000/\$490,000)	\$16,327
Dawson	\$270,000	55.1% (\$270,000/\$490,000)	\$220,408
Total	\$490,000	100%	\$400,000

Step 2 — calculate adjusted Division 6 percentage

In this example, the trustee has not applied losses against any of the trust capital gains for the purposes of working out the distributable income. Bradshaw is therefore only specifically entitled to half (\$50,000) of the non-discount capital gain because he received only half of the net financial benefit of \$100,000. (The net capital loss will still reduce the capital gain for tax purposes.)

Hence, there is \$100,000 of the discount capital gain, \$50,000 of the non-discount capital gain and a \$70,000 franked distribution (with a \$30,000 franking credit attached) to which no beneficiary is specifically entitled. There is also \$100,000 of net rental income.

The 'adjusted income of the trust estate' is therefore \$320,000. Each beneficiary's share of that 'adjusted income' is as follows.

• Beneficiary	• Present entitlement to 'adjusted income'	• Share of 'adjusted income'
Ash	\$50,000	15.6%
Bradshaw	\$0	0%
Claire	\$0	0%
Dawson	\$270,000	84.4%
Total	\$320,000	100%

Step 3 — apply Subdivision 115-C

Applying Subdivision 115-C, capital gains are allocated to a beneficiary based on their specific entitlement and adjusted Division 6 percentage (from step 2). In this example, the calculations are shown on a gain by gain basis for additional clarity.

First gain — capital gain of \$200,000 (discount gain)

• Concept/ provision	• A s h	• B r a d s h a w	• C l a i r e	• D a w s o n
Specific entitlement 115-227(a)	\$100,000	N/A	N/A	\$0
Adjusted Division 6 percentage share 115-227(b)	\$15,600	N/A	N/A	\$84,400
Share of capital gain (amount) 115-227	\$115,600	N/A	N/A	\$84,400
(Total) capital gain	\$200,000	N/A	N/A	\$200,000
Fraction of the gain 115-225(1)(b)	57.8%	N/A	N/A	42.2%
Tax related to gain 115-225(1)(a)	\$100,000	N/A	N/A	\$100,000
Attributable gain 115-225(1)	\$57,800	N/A	N/A	\$42,200
Gross up 115-215(3)	Yes	N/A	N/A	Yes
Extra capital gain 115-215(3)	\$115,600	N/A	N/A	\$84,400

Second gain — capital gain of \$100,000 (non-discount)

• Concept/ provision	• A s h	• B r a d s h a w		• D a w s o n
Specific entitlement 115-227(a)	\$0	\$50,000	N/A	\$0
Adjusted Division 6 percentage share 115-227(b)	\$7,800	\$0	N/A	\$42,200
Share of capital gain (amount) 115-227	\$7,800	\$50,000	N/A	\$42,200
(Total) capital gain	\$100,000	\$100,000	N/A	\$100,000
Fraction of the gain 115-225(1)(b)	7.8%	50%	N/A	42.2%
Tax related to gain 115-225(1)(a)	\$50,000	\$50,000	N/A	\$50,000
Attributable gain 115-225(1)	\$3,900	\$25,000	N/A	\$21,100
Gross up 115-215(3)	No	No	N/A	No
Extra capital gain 115-215(3)	\$3,900	\$25,000	N/A	\$21,100

Step 4 — apply Subdivision 207-B

Applying Subdivision 207-B, franked distributions are allocated to a beneficiary based on their specific entitlement and adjusted Division 6 percentage. (All columns relate to the \$70,000 franked distribution except Claire's, which relates to the \$20,000 net franked distribution).

• Concept /provisi on	• A s h	• B r a d s h a w	• C l a i r e	• D a w s o n
Specific entitlement 207-55(4)(a)	\$0	N/A	\$70,000	\$0
Adjusted Division 6 percentage share 207-55(4)(b)	\$10,920	N/A	\$0	\$59,080
Share of franked distribution (amount) 207-55 (via table)	\$10,920	N/A	\$70,000	\$59,080
Fraction of the distribution 207-37(1)(b)	15.6%	N/A	100%	84.4%
Tax related to	\$70,000	N/A	\$20,000	\$70,000

• Concept /provision	• Ash	• Bradshaw	• Claire	• Dawson
distribution 207-37(1)(a)				
Franking credit 207-35(4)(b)(i)	\$4,680	N/A	\$30,000	\$25,320
Attributable franked distribution 207-35(4)(b)(ii)	\$10,920	N/A	\$20,000	\$59,080

Step 5 – recalculate assessable amounts using Division 6E

The beneficiaries’ assessable amounts under section 97 of the ITAA 1936 are adjusted by the operation of Division 6E, based on the amounts calculated under section 102UY of the ITAA 1936.

- The Division 6E income of the trust estate is still \$100,000, because everything except the net rental income is disregarded. The Division 6E net income is also still \$100,000.
- Ash’s Division 6E present entitlement is \$15,680 (calculated under subsection 102UY(4) of the ITAA 1936 as his present entitlement to trust income of \$150,000 minus his \$123,400 share of capital gains (\$115,600 plus \$7,800) and his \$10,920 share of franked distributions).
- Dawson’s Division 6E present entitlement is \$84,320 (calculated under subsection 102UY(4) of the ITAA 1936 as her present entitlement to trust income of \$270,000 minus her \$126,600 share of capital gains (\$84,400 plus \$42,200) and her \$59,080 share of franked distributions).

The modified amounts assessable under Division 6 are as follows.

• Beneficiary	• Division 6E present entitlement	• Share of Division 6E income	• Section 97 assessable amount
Ash	\$15,680	15.7% (\$15,680/\$100,000)	\$15,680
Bradshaw	\$0	0%	\$0
Claire	\$0	0%	\$0
Dawson	\$84,320	84.3% (\$84,320/\$100,000)	\$84,320

Step 6 — overall result

The following table sets out for each beneficiary the overall tax treatment of the amounts they received from the trust. (It assumes for convenience that beneficiaries had no other capital gains and no capital losses or net capital loss, and are eligible for the franking credits.)

• Concept /provision	•	•	•	•	•
Adjusted section 97 assessable amount	\$15,680	\$0	\$0	\$84,320	\$100,000
Net capital gain 102-5	\$61,700	\$25,000	\$0	\$63,300	\$150,000
Attributable franked distribution 207-37(1)(a)	\$10,920	\$0	\$20,000	\$59,080	\$90,000
Franking credit 207-35(4)(b)(i)	\$4,680	\$0	\$30,000	\$25,320	\$60,000
Total assessable income	\$92,980	\$25,000	\$50,000	\$232,020	\$400,000
Amount received from the trust	\$150,000	\$50,000	\$20,000	\$270,000	\$490,000

- **Specific anti-avoidance rules targeting the use of exempt beneficiaries to inappropriately reduce the tax payable on the taxable income of a trust**

2.170 The amendments in this Schedule introduce two specific anti-avoidance rules into the ITAA 1936. Both are designed to prevent exempt beneficiaries being used to inappropriately reduce the amount of tax payable on the taxable income of a trust.

2.171 These rules do not apply to a trust that is a MIT (or a trust that is treated in the same way as a MIT for the purposes of Division 275) — even where the trustee of the MIT chooses to apply the other amendments in this Schedule that relate to the streaming of capital gains and franked distributions.

[Schedule 2, item 6, subsections 100AA(7) and 100AB(8) of the ITAA 1936]

2.172 For other trusts, these rules may be triggered if a beneficiary that is presently entitled to income is an exempt entity, other than an ‘exempt Australian government agency’.

- As set out in subsection 6(1) of the ITAA 1936 and subsection 995-1(1) an ‘exempt entity’ includes an entity whose income is exempt from income tax.
- An ‘exempt Australian government agency’ includes the Commonwealth, a state or a territory; and a Commonwealth, state or territory authority whose income is exempt as defined in subsection 995-1(1).

[Schedule 2, item 6, paragraphs 100AA(1)(b) and 100AB(1)(b) of the ITAA 1936]

2.173 Broadly, the first rule (section 100AA of the ITAA 1936) treats an exempt entity that has not been notified of their present entitlement to income of the trust estate, within two months of the end of the income year, as not being presently entitled to that amount. *[Schedule 2, item 6, subsections 100AA(1) to (3) of the ITAA 1936]*

2.174 Broadly, the second rule (section 100AB of the ITAA 1936) applies where an exempt entity's adjusted share of the income of the trust estate exceeds a prescribed benchmark percentage. Where this occurs, the exempt entity is treated as not being presently entitled to the 'excess'. *[Schedule 2, item 6, subsections 100AB(1) and (2) of the ITAA 1936]*

2.175 Under both rules, the trustee is assessed under section 99A of the ITAA 1936 on that share of the trust's taxable income that corresponds to the share of the income to which the beneficiary is treated as not being presently entitled. *[Schedule 2, item 6, subsections 100AA(3) and 100AB(2) of the ITAA 1936]*

2.176 As these rules apply to, and potentially adjust, a beneficiary's present entitlement to income of a trust estate, they apply before any of the modifications by Division 6E to amounts assessable under Division 6.

• ***Exempt entity not notified of (or paid) their entitlement***

2.177 Section 100AA of the ITAA 1936 ensures that where an exempt entity is not aware of their present entitlement to income of the trust estate, the trustee rather than the exempt entity is liable to pay tax on the taxable income of the trust that relates to that present entitlement.

2.178 Section 100AA of the ITAA 1936 applies where:

- an exempt entity is presently entitled to an amount of the income of a trust estate;
- the exempt entity is not an exempt 'Australian government agency' as defined in subsection 995-1(1); and
- the trustee has not within two months of the end of the relevant income year either:
 - notified the exempt entity in writing of their present entitlement; or
 - paid the exempt entity the entire present entitlement.

[Schedule 2, item 6, subsection 100AA(1) of the ITAA 1936]

2.179 Written notice of an exempt entity's present entitlement may take the form of a statement setting out an entitlement that is quantifiable (for example a percentage of the income of the trust estate to which the entity is presently entitled). That is, there is no requirement in these amendments that the trustee provide the exempt entity with the actual dollar amount to which the entity is presently entitled. *[Schedule 2, item 6, paragraph 100AA(1)(c) of the ITAA 1936]*

2.180 Payment of an amount of the exempt entity's present entitlement is, to the extent of the payment, taken to be written notice of the entity's present entitlement. *[Schedule 2, item 6, subsection 100AA(2) of the ITAA 1936]*

2.181 Where section 100AA applies, the exempt entity is treated as not being presently entitled, and never having been presently entitled, to income of the trust estate to the extent that the entity was neither notified nor paid that entitlement. *[Schedule 2, item 6, subsection 100AA(3) of the ITAA 1936]*

2.182 The trustee of the trust is then assessed and liable to pay tax under section 99A of the ITAA 1936 on the amount of the taxable income of the trust estate that is attributable to the present entitlement effectively cancelled by the application of subsection 100AA(3) of the ITAA 1936 (unless the Commissioner of Taxation (Commissioner) exercises the discretion provided for in subsection 100AA(4) of the ITAA 1936). *[Schedule 2, item 6, subsection 100AA(4) of the ITAA 1936]*

Example 2.31

In the 2010-11 income year, the Daley Trust generated \$100,000 of rental income. The trust has no other income or expenses and its taxable income is therefore \$100,000.

The trustee of the Daley Trust makes the Philips Trust, a charitable entity, presently entitled to all of the rental income. Ignoring the anti-avoidance rule, the Philips Trust would be notionally assessed on all of the trust's taxable income of \$100,000, although all of that income would be exempt from tax.

However, the Daley Trust fails to provide the Philips Trust with written notice of its entitlement before 31 August 2011 and only makes a payment of \$50,000 to the Philips Trust before that date.

As the Philips Trust is unaware of its full present entitlement it is only notionally assessed on \$50,000. However, the trustee of the Daley Trust is assessed and liable to pay tax under section 99A of the ITAA 1936 on the remaining \$50,000 of the trust's taxable income

2.183 The Commissioner has a discretion to disregard the failure of the trustee to notify the exempt entity of the present entitlement (or pay that entitlement) where he is of the opinion that it would be unreasonable to treat the exempt entity as not being presently entitled to any amount that was neither notified nor paid, having taken into account the factors set out in subsection 100AA(5) of the ITAA 1936. The Commissioner has been provided with this discretion to deal with unfair consequences arising from the application of this anti-avoidance provision. [*Schedule 2, item 6, subsections 100AA(4) and (5) of the ITAA 1936*]

2.184 Where the Commissioner exercises this discretion, the exempt entity is assessed in accordance with the ordinary operation of Division 6 (as then adjusted by Division 6E and Subdivisions 115-C and 207-B).

Example 2.32

In the 2010-11 income year, the Smith Trust generated \$10,000 of interest income. The trust has no other income or expenses and its taxable income is therefore \$10,000.

The trustee of the Smith Trust makes the Quay Trust, a charitable entity, presently entitled to all of the interest income. Ignoring the anti-avoidance rule, the Quay Trust would be notionally assessed on all of the trust's taxable income of \$10,000 (although that income would be exempt from tax).

However, the Smith Trust is unaware that the Quay Trust is an exempt entity until 30 September 2011 and therefore does not inform the Quay Trust of its entitlement before 31 August 2011, but rather at the (later) time when its accounts are prepared and it notifies all beneficiaries of their entitlements for trust purposes. When the Smith Trust becomes aware that the Quay Trust is an exempt entity it takes immediate action to notify the Quay Trust of its entitlement.

As the Smith Trust has taken immediate action to notify the Quay Trust of its entitlement, and it was not unreasonable for the Smith Trust to be unaware of the Quay Trust's taxation status, the Commissioner decides to exercise his discretion under subsection 100AA(4) of the ITAA 1936 to disregard the failure of the trustee of the Smith Trust to comply with subsection 100AA(1) of the ITAA 1936.

Therefore, the Quay Trust is notionally assessed on all of the Smith Trust's taxable income of \$10,000. Had the Commissioner not exercised his discretion, the trustee of the Smith Trust would have been assessed and liable to pay tax under section 99A of the ITAA 1936 on all of its taxable income of \$10,000.

2.185 Subsection 100AA(6) of the ITAA 1936 applies to ensure that where the application of section 99A is triggered, these amendments apply in the same way for both non-resident and resident trust estates. [*Schedule 2, item 6, subsection 100AA(6) of the ITAA 1936*]

- ***Exempt entity's 'adjusted Division 6 percentage' exceeds the benchmark percentage***

2.186 The purpose of the second anti-avoidance rule contained in section 100AB of the ITAA 1936 is to prevent an exempt entity from receiving a disproportionate share of the trust's taxable income, relative to the exempt entity's trust entitlements.

2.187 Broadly, if an exempt entity would otherwise be assessed on a share of the taxable income of trust which exceeds the exempt entity's entitlement to the net accretions to the trust underlying that taxable income (whether 'income' or 'capital' of the trust), that excess is assessed to the trustee.

2.188 Section 100AB of the ITAA 1936 applies even when an exempt entity that is the beneficiary of a trust is informed of, or paid, its present entitlement to income of the trust estate. The section applies subject to the operation of section 100AA of the ITAA 1936. That is, it applies on the basis of a beneficiary's present entitlement to income as determined following the application of section 100AA of the ITAA 1936. This ensures that an amount of present entitlement assessed to a trustee under section 100AA of the ITAA 1936 is not assessed to the trustee again under section 100AB of the ITAA 1936.

2.189 In determining whether an exempt entity would otherwise be assessed on a disproportionate share of the trust's taxable income, the conditions in subsection 100AB(1) of the ITAA 1936 must be satisfied. That is, there must be an exempt entity (excluding an exempt Australian government agency) that is presently entitled to an amount of the income of the trust estate; and that beneficiary's adjusted Division 6 percentage of the income of the trust estate must exceed the benchmark percentage calculated in accordance with subsection 100AB(3) of the ITAA 1936. *[Schedule 2, item 6, subsections 100AB(1) and (3) of the ITAA 1936]*

2.190 Where section 100AB of the ITAA 1936 applies, the exempt beneficiary is treated as not being presently entitled and never having been presently entitled to the amount of the income of the trust estate that is attributable to the percentage by which the exempt entity's adjusted Division 6 percentage exceeds the benchmark percentage. *[Schedule 2, item 6, subsection 100AB(2) of the ITAA 1936]*

2.191 The trustee of the relevant trust is then assessed and liable to pay tax under section 99A of the ITAA 1936 on the taxable income of the trust estate that is attributable to the percentage by which the exempt entity's Division 6 percentage exceeds the benchmark percentage.

- **Adjusted Division 6 percentage**

2.192 As discussed in paragraphs 2.71 to 2.75 these amendments insert a definition of a beneficiary's ***adjusted Division 6 percentage*** into subsection 95(1) of the ITAA 1936. It is the share of the income of the trust estate to which the exempt entity is presently entitled for the purposes of Division 6 excluding capital gains or franked distributions to which any beneficiary or trustee is specifically entitled. *[Schedule 2, item 2, subsection 95(1) of the ITAA 1936]*

- **Benchmark percentage**

2.193 The benchmark percentage against which an exempt entity's adjusted Division 6 percentage is compared is calculated under subsection 100AB(3) of the ITAA 1936. It is the percentage of the 'adjusted net income' of the trust estate to which the exempt entity is presently entitled. *[Schedule 2, item 6, subsection 100AB(3) of the ITAA 1936]*

2.194 The reference to amounts to which the exempt entity is presently entitled is a reference to any amount to which the entity is presently entitled to the extent that it forms part of the trust's adjusted net income. In this context, that may include an entitlement to income or capital. *[Schedule 2, item 6, subsection 100AB(3) of the ITAA 1936]*

2.195 The ‘adjusted net income’ of a trust, is the taxable income of the trust for that income year (as defined in subsection 95(1) of the ITAA 1936) adjusted by the amounts set out in subsection 100AB(4) of the ITAA 1936. It is necessary to adjust the taxable income of the trust in this way to ensure that an entity’s benchmark percentage can be properly compared to its adjusted Division 6 percentage. *[Schedule 2, items 3 and 6, subsections 95(1) and 100AB(4) of the ITAA 1936]*

2.196 Subsection 100AB(4) of the ITAA 1936 adjusts the taxable income of a trust in three ways.

- First, paragraph 100AB(4)(a) reduces the amount of the taxable income of the trust by amounts of any capital gain or franked distribution to which a beneficiary or trustee is specifically entitled.
- Second, paragraph 100AB(4)(b) increases the amount of the taxable income of the trust by any discounts that have been claimed in relation any remaining capital gain.
- Third, paragraph 100AB(4)(c) then reduces the taxable income of the trust by any amounts that do not represent net accretions of value to the trust estate in that income year (other than amounts included in net income under Part IVA of the ITAA 1936).

[Schedule 2, item 6, subsection 100AB(4) of the ITAA 1936]

2.197 Amounts that do not represent ‘net accretions of value to the trust estate’ are amounts that:

- have not added to the trust estate during the relevant income year in terms of monetary additions, property or additions of other value; or
- represent an accretion coupled with a corresponding depletion (in cash or value) of the fund (such as a loan that is coupled with a corresponding liability for the trustee to repay that loan; or a receipt that is depleted by expenses properly chargeable for trust purposes, but which are not allowable deductions for tax purposes).

2.198 Examples of amounts that may be included in a trust’s taxable income, but which do not represent net accretions of value to the trust estate, include:

- the amount of a franking credit included in the calculation of the trust’s taxable income under subsection 207-35(1);
- an amount taken to be a dividend paid to the trustee of the trust pursuant to subsection 109D(1) of the ITAA 1936 (loans treated as dividends under Division 7A of Part III of the ITAA 1936);
- so much of the net income of one trust (the first trust) that is included under section 97 of the ITAA 1936 in the calculation of the net income of another trust, but which does not represent a distribution of, or an entitlement to income of the first trust;
- so much of a net capital gain that is attributable to a reduction of what would have otherwise been a relevant cost base or reduced cost base of a CGT asset as a result of the market value substitution rule in section 112-20; and
- so much of a net capital gain that is attributable to an increase as a result of the market value substitution rule in section 116-30 of what would otherwise have been a relevant amount of capital proceeds for a CGT event.

2.199 An amount included in the taxable income of a trust as a result of the application of Part IVA of the ITAA 1936 is expressly included in the trust’s adjusted net

income, notwithstanding that it does not represent a net accretion of value to the trust estate. Excluding such an amount from the trust's adjusted net income would effectively 'unwind' the work done by Part IVA.

Example 2.33

In the 2010-11 income year, the Bell Trust generated \$100,000 of rental income and \$70,000 of franked distributions (with \$30,000 franking credits attached). The trust had no expenses. The taxable income of the trust is \$200,000 (being the \$100,000 rental income, \$70,000 franked distributions and \$30,000 franking credits).

The trust deed does not define 'income' for the purposes of the trust deed. However, there is a clause that allows the trustee to treat receipts as income or capital of the trust at its discretion.

The trustee determines to exercise this power to treat \$95,000 of the rental receipts as capital and so the income of the trust estate is \$75,000.

Casey Pty Ltd, Mark and Emma are within the class of discretionary objects. Casey Pty Ltd is an exempt entity.

The trustee specifically allocates all of the franked distributions to Mark and appoints all of the remaining income of the trust estate to Casey Pty Ltd (\$5,000). The trustee notifies Casey Pty Ltd of its entitlement by 31 August 2011. The trustee appoints all of the capital in respect of that year to Emma (\$95,000).

Casey Pty Ltd's adjusted Division 6 percentage is 100 per cent ($(\$75,000 - \$70,000 / \$5,000) \times 100$) as it is presently entitled to all of the income of the trust estate after disregarding the \$70,000 of franked distributions to which Mark is specifically entitled.

However, Casey Pty Ltd's benchmark percentage is 5 per cent ($(\$5,000 / \$100,000) \times 100$). The franked distributions to which Mark is specifically entitled and the attached franking credits (because they do not represent net accretions of value to the trust fund) are excluded from the adjusted net income for the purpose of calculating the benchmark percentage.

Casey Pty Ltd's adjusted Division 6 percentage exceeds the benchmark percentage by 95 per cent. The trustee of the Bell Trust is therefore assessed and liable to pay tax on \$95,000 ($0.95 \times \$100,000$) under section 99A of the ITAA 1936.

Casey Pty Ltd's share of the Bell Trust's taxable income is confined to Casey Pty Ltd's entitlement of \$5,000.

Example 2.34

In the 2010-11 income year, the trustee of the Delta Family Trust derives \$90,000 interest. The trustee also receives a distribution from a managed fund of \$10,000, in respect of which it is required to include \$11,000 in its assessable income under section 97 of the ITAA 1936.

The trust has no expenses. Its taxable income is therefore \$101,000. The trust deed does not define 'income'. The income of the trust estate is therefore \$100,000 (comprising the \$90,000 interest and \$10,000 trust distribution).

Notification

The trustee distributes \$6,000 to an exempt beneficiary (a church). As the exempt beneficiary is paid this amount within two months after the end of the income year, section 100AA of the ITAA 1936 does not apply.

Application of benchmark percentage

The adjusted net income of the Delta Family trust excludes \$1,000 of the \$11,000 assessed to it under section 97 of the ITAA 1936 in respect of the trust distribution, as only \$10,000 of that sum represents a net accretion to the trust. The adjusted net income of the trust is therefore \$100,000 and equal to the income of the trust estate.

Accordingly, the exempt entity's adjusted Division 6 percentage is 6 per cent ($\$6,000/\$100,000 \times 100$). The exempt entity's benchmark percentage is also 6 per cent ($\$6,000/\$100,000 \times 100$).

As the exempt entity's adjusted Division 6 percentage equals the benchmark percentage, section 100AB of the ITAA 1936 does not apply.

- *Commissioner's discretion*

2.200 To avoid any unfair outcomes that might result from the application of subsection 100AB(2) of the ITAA 1936, the Commissioner has a discretion to not apply the subsection where he forms the opinion that it is unreasonable for it to apply. *[Schedule 2, item 6, subsection 100AB(5) of the ITAA 1936]*

2.201 In forming an opinion for the purposes of subsection 100AB(5) of the ITAA 1936, the Commissioner must have regard to the matters set out in subsection 100AB(6) of the ITAA 1936, including:

- the circumstances that led to the exempt entity's entitlement being disproportionate;
- the extent to which the exempt entity's entitlement was disproportionate;
- the extent to which the exempt entity received distributions;
- the extent to which other beneficiaries were entitled to benefit from amounts included in the trust's adjusted net income; and
- any other matters the Commissioner considers relevant.

[Schedule 2, item 6, subsection 100AB(6) of the ITAA 1936]

2.202 Where the Commissioner exercises the discretion conferred under subsection 100AB(5) of the ITAA 1936, the exempt entity is assessed in accordance with the ordinary operation of Division 6 (as then adjusted by Division 6E and Subdivisions 115-C and 207-B).

2.203 Subsection 100AB(7) of the ITAA 1936 applies to ensure that where the application of section 99A is triggered, these amendments apply in the same way for both non-resident and resident trust estates. *[Schedule 2, item 6, subsection 100AB(7) of the ITAA 1936]*

- **Application and transitional provisions**

2.204 The amendments made by this Schedule apply in relation to the 2010-11 income year and later income years. *[Schedule 2, item 51, subitem 51(1)]*

2.205 However, applying the amendments may be optional for early balancers and MITs.

- **Early balancers**

2.206 The amendments made by this Schedule only apply to a trust that is an early balancer for the 2010-11 income year where the trustee of that trust makes a choice in accordance with subitem 51(4). The trustee must make this choice in writing and before the end of two months after the commencement of these amendments. *[Schedule 2, item 51, subitems 51(2) to (4)]*

2.207 The Government has provided eligible taxpayers with the ability to make this choice to ensure that they are not disadvantaged by the introduction of these amendments after the end of the relevant trust's 2010-11 income year.

Example 2.35

The Robinson Trust has been granted leave by the Commissioner to adopt a substituted accounting period that ends on 31 December 2010 in lieu of the income year ending on 30 June 2011. The trust is therefore an early balancer for the 2010-11 income year.

Before the end of 31 December 2010, the trustee (acting in accordance with its powers under the trust deed) resolved to distribute capital gains and franked distributions to specific beneficiaries.

To ensure the streaming of these amounts, the trustee of the Robinson Trust makes a written choice on 1 August 2011 to apply these amendments.

The Robinson Trust is therefore subject to the application of the amendments made by this Schedule for its 2010-11 income year

- **Managed investment trusts**

2.208 Further, the amendments made by this Schedule apply to a trust that is a MIT (or a trust that is treated in the same way as a MIT for the purposes of Division 275) for the 2010-11 or 2011-12 income years where the trustee of the MIT chooses to apply these amendments. *[Schedule 2, item 51, subitems 51(5) to (7)]*

2.209 The choice is available for the 2010-11 or the 2011-12 income year. The trustee of the MIT must make this choice in writing and before the end of two months after the later of the commencement of these amendments and the end of the year in relation to which that choice is made. *[Schedule 2, item 51, subitem 51(7)]*

2.210 However, if the trustee makes an effective choice to apply these amendments for the 2010-11 income year, the amendments also apply for the 2011-12 income year. That is, a trustee's choice to apply the amendments for the 2010-11 income year is effectively irrevocable. This is necessary to ensure that it is clear as to which version of the law applies to the relevant trust.

2.211 The Government has included this choice for the trustees of MITs (and certain trusts treated like MITs) in recognition that these trusts generally do not 'stream' capital gains or franked distributions and instead distribute all of their trust income proportionally. In addition, this choice allows MITs to use the current 'proportional approach' in Division 6 until the Government's new MIT regime commences on 1 July 2012.

2.212 The exclusion of MITs (and trusts treated like MITs) from the operation of the specific anti-avoidance rules in section 100AA and section 100AB applies regardless of whether or not a trustee chooses to apply these amendments.

Example 2.36

The Banfield Trust is treated in the same way as a MIT for the purposes of Division 275 for the 2011-12 income year. The trustee of the Banfield Trust did not choose to apply the amendments contained in this Schedule for the 2010-11 income year.

However, on 1 July 2011 the trustee of the Banfield Trust makes an election, in writing, to apply the amendments in this Schedule for the 2011-12 income year. The Banfield Trust is therefore subject to the amendments contained in this Schedule for the 2011-12 income year

- **Consequential amendments**

2.213 Consequential amendments are necessary to reflect the changes to Subdivisions 115-C and 207-B. These Subdivisions now effectively assess capital gains and franked

distributions included in a trust's taxable income (rather than these amounts being assessed under Division 6).

2.214 Broadly, these consequential amendments ensure that existing provisions in the tax laws that look to whether a taxpayer is assessed on part of a trust's taxable income take into account amounts assessed as a result of Subdivisions 115-C and 207-B. Previously, these provisions generally only referred to Division 6 concepts or assessable amounts.

2.215 The Government is aware that, because of complex interactions in the current law, the general consequential amendments may not operate as intended in all cases. However, the application of the general rules to other provisions of the income tax laws is subject to a contrary intention in the law.

2.216 The Government is committed to the introduction of technical corrections on a regular basis to ensure that the tax legislation works and interacts appropriately. Any further consequential amendments will be considered as part of this regular maintenance process.

2.217 The consequential amendments take the form of two general rules and a number of specific amendments.

- **General consequential rules**

2.218 The first general rule ensures that existing provisions that refer to amounts included in a beneficiary's assessable income under section 97, 98A or 100 also include amounts assessable to the beneficiary as a result of Subdivisions 115-C and 207-B. *[Schedule 2, item 1, section 95AAB of the ITAA 1936]*

2.219 The second general rule ensures that existing provisions that refer to amounts assessed to a trustee under section 98, 99 or 99A also include amounts assessable as a result of Subdivisions 115-C and 207-B. *[Schedule 2, item 1, section 95AAC of the ITAA 1936]*

2.220 These rules are intended to apply in respect of references such as those in sections 102AAM and 160AAB of the ITAA 1936 and section 165-60 of the ITAA 1997.

2.221 These rules do not apply to the 'core' provisions within Division 6, Subdivisions 115-C and 207-B — that is, the provisions that effectively assess beneficiaries or the trustee on the taxable income of a trust. In other words, the two general rules translate the effect of the streaming amendments for provisions in the income tax laws that refer to the core provisions, but do not affect the core provisions themselves. *[Schedule 2, item 1, subsections 95AAB(3) and 95AAC(5) of the ITAA 1936]*

- **Specific amendments**

2.222 The specific consequential amendments fall into two broad categories:

- removing or updating guide material and provisions that are no longer consistent with the changed application of Division 6 and Subdivisions 115-C and 207-B; and
- amendments to provisions within Division 6 to ensure that they interact appropriately with the two general consequential rules.

[Schedule 2, items 20, 21 and 28 to 50]