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Dear Lyn

ATO Interpretive Decision ATO ID 2011/58

On 22 July 2011 the Australian Taxation Office (**ATO**) published ATO Interpretative Decision ATO ID 2011/58 (**ATO ID 2011/58**). The topic was 'Income tax: whether trust distributions can be assessed under section 6-5 of the ITAA 1997'. ATOID 2011/58 has significant implications, not only for insurance companies to which it is addressed but the many businesses which are taxed on revenue account on a net profit basis with respect to their interests in trusts, such as banks and other financiers, construction firms, developers etc.

We therefore would like to highlight a number of issues we see in the reasoning provided by the ATO in ATO ID 2011/58. Because of the importance of the topic we consider it should be identified as a high priority technical issue and escalated to the rulings process for review by the Public Rulings Panel.

Much of ATO ID 2011/58 is addressed to the operation of the specific trust taxing provisions and their relationship with the rest of the income tax legislation. Three important issues are raised in the ruling:

1. What it means to be taxed on revenue account on a net profit basis.

2. What is the relationship between Division 6 of the *Income Tax Assessment Act 1936* (**the 1936 Act**) and the rest of the income tax legislation.

3. How is potential double taxation prevented?

The first issue is not clearly addressed in ATO ID 2011/58 and in our view is the most important, so we start with this issue.

1. Taxation of Revenue Assets

'Revenue asset' is the term invented by Professor Parsons in *Income Taxation in Australia* (1985 available at http://setis.library.usyd.edu.au/oztexts/parsons.html) to describe assets which are taxed on a net profit basis on revenue account, to distinguish the tax treatment from taxation on a receipts and outgoings basis on revenue account. The assets of insurance companies which are held to meet claims fall into the revenue asset category, along with many other transactions.

Although it took some time for case law to recognise explicitly that there are two bases for working out income on revenue account, recent authority is clear on this issue, see Parsons

[11.7]-[11.23], and the difference is now recognised in the legislation in many places, including a definition of revenue asset in *Income Tax Assessment Act 1997* sections 977-50, 995-1 (**the 1997 Act**). The difference is that for receipts and outgoings treatment the full amounts received or receivable enter assessable income, whereas it is only the profit on realisation of a revenue asset which enters assessable income. Correspondingly for the receipts and outgoings method the full amount paid or payable is deductible immediately or over time whereas for revenue assets it is only a loss on realisation that is deductible.

It is not clear if ATOID 2011/58 recognises this fundamental difference. It states:

> *Where an investment made by an insurance company produces distributions of a particular kind which are regularly received in the course of carrying on the insurance business, and are not received in respect of the realisation of the underlying investment, then the gross distributions are properly characterised as revenue receipts and as such should be included in the company's assessable income under section 6-5 of the ITAA 1997.*

There is no authority quoted for this proposition and in our view there is none. The interaction of receipts and outgoings accounting with net profit and loss accounting for assessable income requires a much more detailed analysis as otherwise the difference will be "confounded" (see Parsons [12.17]).

If an insurance company invests in a building which it rents out, the rent will be ordinary income in its full amount and, putting aside TOFA and other specific provision on financial instruments, the same would be true of interest on a bond in which an insurance company invests. If the insurance company invests in shares, the dividends will be assessable in full under the 1936 Act section 44(1). The same will apply for expenses that are the subject of a specific deduction provision which operates on gross amounts. The problem of double counting is dealt with, e.g., in the case of deductions by the 1936 Act section 82.

In the case of ordinary income this result arises because rent and interest are ordinary income, not because the investment is a revenue asset – the interest and rent are equally ordinary income if the asset is held on capital account. In the case of dividends the result follows because dividends are expressly made statutory income.

In effect the passage quoted above inverts the logic and reasons that anything received in respect of a revenue asset which is not part of the realisation of the asset is ordinary income *because* the asset is a revenue asset. There is no authority for this proposition that we are aware of. The cases on revenue assets deal only with the amount that is profit or loss on realisation, that is, what amounts enter as revenue and expense in striking the profit or loss, and when that profit or loss is assessable as ordinary income or deductible under the 1997 Act section 8-1.

Whether an amount received or receivable that does not enter the striking of profit of loss on a revenue asset is ordinary income is left to the general principles of ordinary income and there is no general principle we have ever seen which has suggested that such amounts received in respect of revenue assets are ordinary income because they are received in respect of a revenue asset. (For statutory income it is just a matter of whether they are covered by a provision on statutory income). We realise that we have repeated the same point on a number of occasions but it is vital to understanding the way in which revenue assets are taxed.

ATOID 2011/58 might be proceeding on the basis that investment in a trust is the same as investment in a share (or bond or rental property) and that amounts received other than on realisation are ordinary income. If so the result should be the same whether the investment is held on revenue or capital account. Such a view would not only fly in the face of the income tax legislation (e.g., 1936 Act section 99B, 1997 Act section 104-70) but would also contradict the highest case authority in Australia. The High Court has made clear on more than one occasion that it is not valid to equate or elide shares and interests in a trust in this way in determining whether an amount is income, e.g., *Charles* (1954) 90 CLR 598, *Read v Commonwealth* (1988) 167 CLR 57.

Moreover, the whole history of trust taxation in Australia has been premised on the basis that *all* distributions by a trust in respect of an interest in the trust are *not* ordinary income and hence special provisions are required to deal with trusts, see Harris, *Metamorphosis of the Australasian Income Tax* (2002) pp. 189 (1915 Act), 194-195 (1918 Act), 200 (1922 Act).
In our view the whole reasoning on which the ATOID's base falls because it uses an inverted logic that has no justification in the legislation, case law or history to treat distributions by trusts on interests which are revenue assets as ordinary income.

2. Division 6: Relationship to the rest of the income tax legislation

There has been considerable debate over the years about the relationship of the trust taxing provisions in the 1936 Act Division 6 (**Division 6**) and the rest of the income tax legislation. ATOID 2011/58 treats this issue very briefly and as if it has been the same issue over the years:

> *"The fact that the distributions are from a trust does not alter that result. The scope of Division 6 was considered by the High Court in Tindal v. Federal Commissioner of Taxation (1946) 72 CLR 608; (1946) 8 ATD 152; (1946) 3 AITR 608, Federal Commissioner of Taxation v. Belford (1952) 88 CLR 589; (1952) 10 ATD 105; (1952) 5 AITR 392 (Belford) and Union Fidelity Trustee Co v. Federal Commissioner of Taxation (1969) 119 CLR 177; 69 ATC 4084; (1969) 1 ATR 200 (Union Fidelity). The majority view in Belford that Division 6 was not an exclusive code was affirmed in Union Fidelity."*

In fact the relationship issue has been a moving target as the legislation has been amended on many occasions in ways which deal directly or indirectly with the issue. Accordingly, case law on earlier legislation has to be considered in the context of the legislation on which it was decided and reconsidered in the context of the current legislation before any conclusions can be drawn from it.

It is often said that Division 6 is a code but what exactly is meant seems to vary, though it seems common to code arguments that amounts that would otherwise be ordinary income on certain grounds are no longer ordinary income for reasons similar to *Reseck* (1975) 133 CLR 45. The question is what grounds for ordinary income are being dealt with by the code argument. (There are also cases of potential overlap of Division 6 with other kinds of statutory income which involve seeking an interpretation which best reconciles two different statutory income regimes. This is not an issue in ATOID 2011/58 which deals with the relationship issue with respect to ordinary income only).

This use of the word "code" also derives from Parsons, e.g. [1.41], but as the High Court demonstrated in *McNeil* [2007] HCA 5 at [39]-[50], it is not a meaning which resonates with them, so in what follows we generally refer to it as the relationship issue.

As a starting point it has probably always been the case and certainly is nowadays the case that an amount passing through a trust to a beneficiary can be assessable income outside Division 6. The relationship argument is not generally intended to state otherwise.

Take the case of an annuity payable by a trustee to an annuitant/beneficiary of the trust. Annuities are ordinary income (Parsons [2.172]ff), or at least were prior to the changes that were introduced in 1922 expressly assessing the amount of annuities excluding the return of the capital for a purchased annuity, see Harris p.198. In 1922 it would seem that the ordinary income treatment of annuities was displaced (*Reseck*: whether this is so or not is not germane to the reasoning here). Thus when the predecessor of Division 6 was introduced in 1918 it is likely that annuities were nonetheless assessable in full as ordinary income even if paid from capital.

Coming forward to the present, annuities (or parts of them) are still taxable outside Division 6 under a combination of the 1936 Act section 27H and Division 16E, and possibly the 1997 Act Division 230. Similarly a beneficiary can be assessed on other trust distributions as statutory income under the 1997 Act section 102-5 as a result of one of a number of CGT E events.

We have indicated above that there is no authority that, putting aside the parts of the income tax legislation creating statutory income, *all* trust distributions would be ordinary income. It is likely that a *distribution of trust income* (i.e. income viewed from the point of view of the trustee) would have been ordinary income, *Drummond v Collins* [1915] AC 1011, quoted in *Traknew* [1991] FCA 129 at [57], but as the Commonwealth tax legislation has always had provisions dealing with this issue, in our view that possibility has been to a greater or lesser extent excluded from the beginning on the same basis as the reasoning in *Reseck*.

That is, what in our view is often meant by saying that Division 6 is a code in discussing the relationship issue is that a distribution of trust income from the trustee's perspective is not ordinary income to the extent that Division 6 covers it. (We are deliberately leaving ambiguous the meaning of income from the trustee's perspective – it could be trust law income or some form of tax law income – since if the relationship issue argument here is correct, it does not matter what the meaning of trust income is for this purpose.)

Our reading of the case law referred to in ATOID 2011/58 supports this view rather than the ATO view expressed there. That is, in situations where the courts have held that Division 6 does not prevent an amount being ordinary income, it is either because Division 6 simply did not deal with the type of income in question or that the amount was ordinary income on some ground other than as a distribution of trust income.

ATO ID 2011/58 refers to *Tindal*, *Belford* and *Union Fidelity* on this issue (all cases on very different forms of Division 6 to the present version). Another case on a much more recent version of Division 6 which needs to be considered is *Traknew*.

Tindal involved an annuity paid to a widow under a will. The fact that in that case the High Court also referred to the character of the amount in the hands of the recipient was wholly unsurprising given that the annuity was payable out of income as well as the corpus of the trust if trust income was insufficient. The amount was also made income under the provision in the legislation dealing with annuities, so whether viewed as ordinary income or statutory income it was assessable because it was an annuity not because it was a distribution of trust income.[1]

[1] *Tindal* is also sometimes seen as relevant as to whether trust income retains its character. It is hard to see why as the provisions in question made clear that a business had to be carried on by the person assessed on the income for it to qualify as income from personal exertion which says nothing as to the retention of character of trust income in a general sense, see *Greenhatch* [2011] AATA 479.

Both *Belford* and *Union Fidelity* concerned a very specific fact pattern which is clearly distinguishable from the one examined in ATOID 2011/58. In both cases the High Court looked at ordinary income derived by a trust estate which was sourced out of Australia, which was not an issue expressly dealt with by Division 6 at the time of each of those cases and which the cases held was not dealt with by Division 6 by implication. In contrast, the fact pattern examined in ATOID 2011/58 concerns amounts which are quite clearly covered by Division 6 in the sense that they enter into the calculation of net income in one way or another (see the dot points under facts and notes 1 and 2 – when we say an amount is covered by Division 6 or dealt with by Division 6 we mean that the amounts get taken into account under Division 6 even if they do not form part of net income because of a deduction, CGT discount etc.).

The distinction is evident from Dixon CJ's judgement in *Belford* where it is observed at 596:

> *"Division 6 which, although headed "Trustees", deals not only with trustees but with the liability of a beneficiary obtaining income from a trust estate,* ***is based upon provisions introduced into the legislation at a time when the territorial liability for income tax was based exclusively on the source of the income and when residence was not a test of such liability. The difficulty of applying the provisions in relation to liability based on residence is the probable explanation of the trouble which has been experienced in solving the present problem*** *(emphasis added)"*

Similarly, in *Union Fidelity* Barwick CJ (representing the majority) states at [15]:

> *"there is no room in applying the provisions of Div. 6 of Pt III of the Act to have regard to the residence of a beneficiary"*

Both Dixon CJ and Barwick CJ's judgments make it clear that the High Court in each of those cases was contemplating a very different question to the one posed by the ATO in ATOID 2011/58 and accordingly, the judgments must be put into context.
Notably also in *Belford* the minority noted that it was appropriate to look at the right to the share of income of the trust not the actual receipts (*Belford* per Taylor J at 605-606). At 607 Taylor J also states:

> *"It is to me inconceivable that the Act which, in Div. 6, requires a beneficiary presently entitled and whether under a disability or not to include as part of his assessable income for any year his appropriate share of "net income" of the trust estate for that year whether or not he has received any part of that income, should be taken to intend that such a beneficiary must also include in his assessable income for that or any later year his actual receipts upon a distribution of the estate income. The provisions contained in Div. 6 appear to me to cover the whole field and upon a review of the various sections contained in the division, I am of the opinion that, within the scope of its operation, it makes exclusive provision for the levying of tax upon income from trust estates and to this extent the respondent's argument must, I think, succeed."*

It also should be noted that although Barwick CJ in *Union Fidelity* was of the view that Division 6 did not cover trust income distributed before year end, the other judges who agreed with him did not make the same observation nor did those in the minority. In particular, Barwick CJ in examining the operation of Division 6 of the 1936 Act and the potential for another provision of the Act to apply, only talks about amounts of *income* (i.e. from the trustee's viewpoint). It is in our view an impermissible leap to then talk about amounts that are not income from the trustee's perspective being assessable in the hands of the beneficiary as ordinary income. Additionally, Kitto J in *Union Fidelity* narrowed the operation of section 26(b) (see [7] of his judgment) but not necessarily of section 25(1).

In our view these cases are identifying situations which were not covered by the then Division 6 in any sense and thus with respect to which the relationship issue does not arise. Because the judges quite clearly reason in this way in reaching their conclusions, it follows that they accepted some version of the relationship issue being resolved by excluding from ordinary income amounts covered by Division 6.

The legislation was extensively amended in 1979 to reverse the outcome of and various comments in these two decisions. The amendment is a strong indication of the legislative intention to maintain Division 6 as a far-reaching, if still not completely exclusive, means for the taxation of trust income. This is supported by the Explanatory Memorandum to the *Income Tax Assessment Amendment Act 1979*.[2] which introduced sections 95A(1) and 99B of the 1936 Act, which states of section 99B:

> *"the amendments to be made by these clauses are designed to ensure that resident beneficiaries are subject to Australian tax* ***under the trust estate provisions*** *both on income from Australian sources and, subject to relief from double taxation where it is also taxed in the country of source, on income from foreign sources, while non-resident beneficiaries are taxed only on income from Australian sources (emphasis added)."*

The Explanatory Memorandum goes on to state:

> *"a technical amendment is* ***proposed to clarify the intention of the law*** *that the payment to or application of income for the benefit of a beneficiary who was presently entitled to the income does not prevent the assessment of that income on the basis of the rules that apply to income to which a beneficiary has a present entitlement (emphasis added)".*

As it is possible for trust distributions of income from the trustee's perspective to form ordinary income as trust distributions, all this effort of refining the legislation would have been pointless if it did not intend to exclude that possibility. It is not surprising therefore that Hill J in *Traknew* expressed at [57] a reservation that former section 25 of the 1936 Act could operate independently of Division 6 and former section 26(b), stating that there were strong indications that Division 6 together with the former section 26(b) of the 1936 formed an "exclusive code" for the taxation of trust distributions. Hill J considered that this is evident by the way sections 97 and 98 of the 1936 Act which operate where a beneficiary is presently entitled are mutually exclusive with sections 99 and 99A which operate where there is no present entitlement. He also noted at [58]-[62] the extreme width of section 99B (which would potentially treat all forms of trust distributions as assessable except those excepted by section 99B(2)) and indicated that it would likely be read down in view of its purpose of dealing with distributions to resident beneficiaries of foreign source accumulated income of foreign trusts.

This is the most authoritative discussion of the 1979 amendments and should be included in any consideration of the Division 6 relationship issue. It is strongly against any view that *all* trust distributions can be ordinary income, that *distributions of trust income* from the trustees point of view can be ordinary income, or that *distributions to holders of trust interests as revenue assets* can be ordinary income.

[2] Introduced as the *Income Tax Assessment Amendment Bill (No. 5) 1978.*

The introduction of 1936 Act section 160ZM in 1986, now CGT event E4, seems similarly to be motivated by a view that the distribution of trust income in excess of net income could be ordinary income or otherwise assessable. The repeal of 1936 Act section 26(b) in 2006 as redundant does not affect the analysis since, as a result of CGT event E4 acting as a complement to Division 6, the difference between tax law income and trust law income is brought to account on its distribution (see further section 3 below).

The ATO published Income Tax Ruling IT 2512 in 1998 in relation to financing unit trusts. While the fact situation was quite specific, it is now apparently seen as a 'shot across the bow' for revenue holders of units in trusts. This is quite contrary to the statement in para.31 of IT 2512:

> *31. **It should also be emphasised that this Ruling does not extend to situations where, in the case of an ordinary trust**, a distribution is made in excess of the net income for tax purposes. The excess, which may be referable to allowable tax deductions, should not be assessed on the basis of this Ruling. An ordinary trust **would in this context include** a family trust whether the trustee made investments or carried on a business, or a trust created by a will or **a unit trust where the beneficiaries or unitholders are entitled to both corpus and income of the trust**, i.e. they are effectively exposed to all the risks of ownership and participate in the profits of the trust. The interests in such a trust are not ones where it could normally be concluded that the beneficiary or unitholder is obtaining a return on commercial activities carried on by the beneficiary or unitholder. [emphasis added]*

Reasonably, many at the time thought the ruling was confined to the particular kind of arrangement that was described. Although not mentioned otherwise than as a related ruling in the table at the end it appears it has not been so read in ATOID 2011/58.

This view of the ATO also appears in the input of the ATO into the Board of Taxation review of the managed investment trust regime. In the August 2009 report of the Board, it became clear that the ATO had raised a proposal that involved taxing revenue account holders on all distributions. However, this did not find favour with the Board and retention of the conduit approach was part of the recommendations. Nonetheless, in responding to the recommendations, the Government (no doubt after advice by Treasury and the ATO), made it clear that that part of the recommendations regarding tax deferred distributions would not apply to revenue account unitholders – this was reflected both in the attachment to the Assistant Treasurer's Press Release[3] and in the Treasury Discussion Paper[4] which ensued.

Whether or not Government will implement this distinction (and how exactly they will do so) remains to be seen but the analysis above indicates that such a change requires new legislation, not interpretation of the current legislation.

3. Double Taxation

ATOID 2011/58 acknowledges that the views expressed on the first two issues above produce the result that double taxation would be produced by the normal operation of the other provisions of the income tax legislation and would not be solved by the many mechanisms that the legislation contains to deal with double taxation. The ATO resorts to "the general structure, language and purposes of the income tax law" for the view that

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[3] Hon Nick Sherry,(Assistant Treasurer) 'New Tax System for Managed Investment Trusts' (Press Release, 7 May 2010), Attachment B.

[4] Hon Bill Shorten (Assistant Treasurer), *Implementation of a new tax system for managed investment trusts: Discussion Paper*, October 2010.

inclusion of the same amount under sections 6-5 and 102-5 will not occur though that result otherwise seems to flow from its analysis.

In our view, this double taxation issue is a clear sign that the preceding analysis in ATO ID 2011/58 is incorrect.

If, as we think is clear, holders of trust interests as revenue assets are not taxed on the difference between trust law income and tax law income, the question remains of their tax treatment. One possibility is that the cost of the revenue asset for purposes of assessment of profits on realisation under 1997 Act section 6-5 is written down by the difference just as it is generally for CGT purposes. The case law on how profits and losses on revenue assets are calculated does not deal in any clear way with this issue, though we understand that many revenue asset holders do make such write downs.

If no write down is the correct approach for revenue asset purposes, then a combination of the CGT provisions and the ordinary income provisions as mediated through the 1997 Act section 118-20 for overlap purposes will deal with most of the issues to bring the excess ultimately to account under the CGT regime.

In our view the fact that the legislation would deal satisfactorily with most double tax concerns if the ATO ID 2011/58 views on the first two issues are rejected is another strong indicator that the ATO views are incorrect.

Should you have any queries with respect to any of the matters raised above, please do not hesitate to contact me on (02) 8223 0011 or The Tax Institute's Tax Counsel, Deepti Paton on (02) 8223 0044.

Yours sincerely

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