WHAT SHOULD BE THE TIMING RULE FOR ‘DERIVATION’ OF ASSESSABLE INCOME BY BENEFICIARIES OF DISCRETIONARY TRUSTS?

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The accepted principle of the tax accounting rules for taxpayers’ assessable income inclusions is that a receipt or entitlement must have arisen or accrued before year-end in order to support an assessable inclusion for that year. In spite of this, for at least 45 years of Australia’s income tax, the tax accounting rule for beneficiaries of discretionary trusts has not been a year-end rule; it has been (at least) a two month post year-end rule. It is only recently that the rule has been ‘restored’ to a year-end rule. While no final decision has been made yet, it is clear that the current trust tax review strongly favours a post year-end rule for beneficiary derivation; in fact, there is little evaluation of a year-end rule. This article examines the merits of a year-end rule as opposed to a post year-end rule. Even though the discretionary trust is a problematic and unique ‘entity’, this article contends that the arguments for having a post year-end derivation date for taxation of a beneficiary of a discretionary trust are not convincing.

1. INTRODUCTION

Amongst other things, the review regarding the rewrite of the trust tax provisions raises the issue as to what should be the proper ‘derivation’ or ‘entitlement timing rule’ for beneficiary taxation under the proposed regime (ie, rewritten Division 6 of

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the Income Tax Assessment Act 1936).1 This issue is not new and has been simmering away well before the current trust tax review; it has been present for at least 45 years.2 The two alternatives usually suggested (and that have been taxation law and practice at various times) are: (i) beneficiary derivation or entitlements must be created by the end of the relevant income year and (ii) beneficiary derivation or entitlements must be created within a period some time after the end of the income year; two months after year-end has considerable support. Strangely, the latest discussion paper considering options for reform of the trust taxation provisions seems to accept that the entitlement date, at its earliest, will be two months after year-end; a year-end date for entitlements is not seriously contemplated.

2 Australian Taxation Office, Trusts: Interpretation of Section 101 In Relation to Sections 99 and 99A Under 1964 Amending Legislation, IT 328, 20 May 1966 (‘IT 328’). In this ruling, the ATO indicated that a strict application of the present entitlement concept may require the establishment of an accrued entitlement by year-end; at [32]. However, as an administrative practice, the ATO permitted trustees to create present entitlement within two months post year-end (see Sub-Part 2.2.1 for a fuller explanation). IT 328, along with the two month administrative practice, was withdrawn with effect from 1 September 2011. Some nine years after IT 328 was written, Taxation Review Committee, Commonwealth of Australia, Taxation Review Committee: Full Report (AGPS, 1975) (‘Asprey Report’) [15.10] indicated that it was not clear whether the creation of present entitlement after the end of the income year meant that the beneficiary would be allocated the taxable income for that income year.
3 On one level, it is extraordinary that a year-end entitlement date is not contemplated or discussed in a meaningful manner.
At first glance, consistency with derivation rules for other taxpayers and the desire for tax equity suggests a year-end rule. However, the former ATO practice (withdrawn two years ago) over a considerable period and the content of ‘recent debate’ supports a derivation date beyond year-end. Logic suggests that trustees of discretionary trusts\(^4\) will be able to achieve a higher degree of ‘tax efficiency’ from their allocations if the timing rule is a substantial time after year-end, compared to the situation where the timing rule is by year-end.\(^5\) However, even with a year-end timing rule, trustees should still be able to achieve a fairly high degree of tax efficiency in their allocations.

This article examines the considerations that should and may be taken into account in addressing this beneficiary derivation issue. In spite of the derivation issue being somewhat different where discretionary trusts are involved, it is submitted that many of the considerations surrounding derivation in the income tax (ie, outside of the discretionary trust situation) can be a basis for determining what the proper rule should be for discretionary trusts.

This paper is structured as follows. Part 2 provides an outline of the current rules concerning derivation of assessable income in the income tax generally. Part 2 also provides an outline of the current derivation rules within the trust taxation regime (eg, present entitlement, share of net financial benefit regarding capital gains). The outline in Part 2 provides a basis for the discussion in Part 3. Indeed, given the limited range of

\(^4\) ‘[T]he usage of the term “discretionary trust” is essentially descriptive rather than normative. The meaning of the term is primarily a matter of usage, not doctrine’; *FCT v Vegners* 89 ATC 5274, 5278. In spite of this statement, in this article the term discretionary trust is used to describe an express trust where the trustee has a power to appoint income (or capital) to a person within a class of potential beneficiaries.

\(^5\) The term ‘tax efficiency’ is used in this paper to refer to a lower tax impost (or ATO liability) in regard to a given level of taxable income.
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derivation options available and that the outline in Part 2 deals with the various options that have been used over, at least, the last 47 years. Part 2 lays much of the groundwork for the discussion in Part 3. Part 3 examines the merits of the two main options, mainly against the equity criterion, or a consistency criterion. Even though the discretionary trust is a problematic and unique entity that does not allow for easy comparisons, the paper contends that arguments for having a derivation date beyond the end of the income year for taxation of a beneficiary are not persuasive. Following this analysis, some conclusions are noted.

2. THE ‘DERIVATION’ RULES GENERALLY AND CURRENT DERIVATION RULES FOR BENEFICIARY TAXATION

2.1 Assessable Income Charging Provisions Generally and Taxable Income Generally

2.1.1 Direct Derivation

For current purposes, a direct derivation is where the taxpayer is the party (only party) to the transaction and/or there is no intermediary or interposed ‘entity’ involved. In regard to the accruals basis of derivation in regard to income, the focus is on whether a receivable has arisen such that the taxpayer has an entitlement to call for payment, either immediately or in the future. And, the accrual of the entitlement has to have a fairly high degree of certainty.\(^6\) In regard to the cash basis of income derivation, the focus is on receipt or constructive receipt of

\(^6\) BHP Billiton Petroleum (Bass Strait) Pty Ltd & Anor v FCT 2002 ATC 5169, 5177-88.
cash.\textsuperscript{7} Both forms of derivation must have occurred by year-end to have the relevant tax amount included in assessable income.\textsuperscript{8}

It is worth noting that the level of assessable income or deductions, and hence, taxable income, in regard to some items is not determined and is not determinable by year-end as the tax law expressly contemplates or permits a date of determination later than year-end. For example, taxpayers can choose, from one of three bases, the value of an item of closing trading stock on hand.\textsuperscript{9} Different valuations can lead to a different level of assessable income or deductions and in turn, taxable income. Even though the legislation is silent on the issue, the choice can be made as late as the lodgment date for the relevant tax return.\textsuperscript{10} Subject to a few exceptions,\textsuperscript{11} wherever the capital

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\textsuperscript{7} \textit{Brent v FCT} 71 ATC 4195.
\textsuperscript{8} It is worth adding that the focus of the income derivation concept is on entitlements or otherwise to payments under the general law or commercial law (eg, has a receivable (debt) come into existence). The tax law places a character (income or capital) on these general law events or transactions for the purpose of the income section. Assessable income charging provisions do not expressly make this delineation but it is necessarily present.
\textsuperscript{9} \textit{Income Tax Assessment Act} 1997 (Cth) s 70-45(1) (‘\textit{ITAA 1997}’).
\textsuperscript{10} Australian Taxation Office, \textit{Income Tax: Can a Taxpayer After Lodging a Return But Before Any Assessment is Made Alter the Figure for Closing Stock by Adopting a Different Basis of Valuation to That on Which the Return Was Originally Prepared?}, TD 94/10, 27 January 1994, [2]. Indeed, at [4], this determination states that a taxpayer can alter their election any time before the ATO issues an assessment for the relevant income year. Similar rules apply with respect to: (a) choosing the obsolete stock valuation method of valuing closing trading stock on hand, see \textit{ITAA 1997} s 70-50; and (b) choosing between actual costs or prescribed costs for natural increase of livestock; s 70-55.
\textsuperscript{11} The exceptions are where a particular provision specifies a separate rule (eg, s 115-230(5), whereby the choice for a trustee to be taxed on
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gains tax (CGT) regime offers taxpayers a choice, taxpayers can exercise the relevant choice as late as the lodgment date of the relevant tax return.\textsuperscript{12} How choices are exercised determines the amount of a capital gain, and often, assessable income, for a particular income year\textsuperscript{13} and (iii) taxpayers can choose one of two depreciation methods (prime cost or diminishing value) to apply to a newly purchased depreciable asset.\textsuperscript{14} The respective methods will provide a different amount of deductions for most years of the asset’s holding period. Again, the legislation permits the choice to be made as late as the lodgment date for the relevant tax return.\textsuperscript{15}

2.1.2 Principal-Agent Relationship

The focus here is on the type of agency whereby the agent has the actual power to bind the principal through entry into transactions, that is, a principal-agent relationship under agency

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\textsuperscript{12} Sec 103-25(1). This general rule does not apply where a particular provision specifies a separate rule (see, eg, s 115-230(5): choice for trustee to be taxed on capital gain (instead of beneficiary) is to be made within two months of year-end).

\textsuperscript{13} See, eg, (a) s 118-145: choice to treat dwelling as main residence during period of absence; (b) s 102-5(1): choice as to order of application of capital losses and net capital losses against capital gains; (c) s 122-15: choice to rollover of capital gain or capital loss where asset disposed of to wholly owned company; and (d) ss 124-10, 124-70: choice to rollover capital gain or capital loss in cases of involuntary disposals.

\textsuperscript{14} Sec 40-65(1).

\textsuperscript{15} Sec 40-130(1). The same rule applies in regard to other choices under Division 40 that determine taxpayers’ assessable income for an income year (eg, rollover relief for balancing charge on variation of interests in asset: see s 40-340(2); and see also s 40-365: rollover relief for a balancing charge on involuntary disposal).
law, rather than just a ‘commercial’ agency arrangement. The short point here, it is submitted, is that when an agent enters into a transaction on behalf of the principal, it is the principal that is contracting with the third party. Aside from furtherance of a particular policy, there is no reason why the income tax law should not recognise this. Accordingly, it should be the principal that derives the tax amount. It therefore follows that all the normal derivation rules should apply to the principal.\textsuperscript{16}

2.1.3 Partner in Partnership

The structure of the partnership taxation regime seems to require two-steps. First, the partnership is treated as a taxpayer for the purpose of determining the (collective) taxable income (or tax loss) of the partnership. The normal direct derivation rules apply at this first step. Secondly, after ascertaining taxable income, it is allocated to the partners in proportion to each partners’ interest in the taxable income, which is based on their interest in partnership profits.\textsuperscript{17} Importantly, it is the partners’ interest in profits as at 30 June that is relevant.\textsuperscript{18} A partner who has assigned a portion of their interest in the partnership, before year-end, to another entity ceases to have an interest in the

\textsuperscript{16} See \textit{CC (New South Wales) Pty Ltd (in liq) v FCT} 97 ATC 4123, 4138-45. Even though the finding of fact was that there was no principal-agent relationship on the facts, it is strongly arguable that had there been such a relationship, the principal would have derived the relevant income (and not the agent).

\textsuperscript{17} It is impossible to see how a taxpayer can have an interest, in a beneficial sense, in an artificial concept like taxable income; \textit{FCT v Bamford & Ors; Bamford & Anor v FCT} 2010 ATC 20-170, [45] quoting \textit{Zeta Force Pty Ltd v FCT} 98 ATC 4681, 4686 (Sundberg J). This suggests that one needs to first determine a partner’s interest in partnership profits, and then use that (proportionate) interest to determine the taxable income allocation for each partner for the purposes of s 92(1) of the \textit{ITAA 1936}.

\textsuperscript{18} \textit{Rowe (B & H G) v FCT} 82 ATC 4243, 4244.
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whole year’s profits (and losses) attributable to the assigned interest.¹⁹

There does not appear to be any judicial guidance on the retention of character issue regarding partnerships. However, given that a partnership is a fully transparent ‘entity’ under Australia’s tax income tax system - effectively a collection of sole traders – it is submitted that gains retain their character on allocation to partners.²⁰

2.1.4 Shareholder in a Company

The central charging criterion for a shareholder who shares in a company’s profits is the payment of a dividend. There is no assessable income inclusion for the shareholder until the company has paid the dividend.²¹ It is also worth noting that final dividends paid to shareholders are usually sourced in profits made in the previous financial year.

It is accepted that gains made at the company level do not retain their character when the gain is distributed as a dividend to shareholders.²² Given there is no retention of character of

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¹⁹ *FCT v Everett* 80 ATC 4076; *FCT v Galland* 86 ATC 4885.

²⁰ Certainly, franked dividends received by a ‘partnership’ retain their character on pass-through to partners; see *ITAA 1997* ss 207-35, 207-45, 207-50, 207-55, 207-57.

²¹ *ITAA 1936* s 44(1).

²² In terms of tax as opposed to company law, it is somewhat difficult to pin-down the precise authority for this but it is likely that *ITAA 1936* s 44(1) is the authority through its use of the concepts of ‘dividends’ and ‘profits’ along with judicial explanation of those concepts. The doctrine of separate legal identity of the company may also be a factor. Further, there are numerous provisions in the income tax that seem to assume there is no retention of character for tax purposes on pass-through of gains (see, eg, *ITAA 1997* s 152-125: small business 15 year CGT exemption expressly preserved on pass-through of gain to
gains made at the company level when amounts representing those gains are passed through to shareholders, there can be no streaming as such of gains made at the company level.23

A shareholder in a private company can prevent an (unfranked) deemed dividend arising under s 109D(1) if the shareholder repays a loan made to the shareholder by the private company before the time the private company is required to lodge their tax return for the income year in which the loan was made.24 A private company is allowed four months after year-end to give a distribution statement to a shareholder who has received a distribution in an income year.25 While the legislation does not expressly say so, this has been taken to mean that the private company has until four-months after year-end to decide the extent to which the distribution is franked.26 This means that the amount of assessable income (representing the gross-up)27 of the shareholder for an income year can be affected by a decision made by the company after year-end.

shareholder; see also s 152-325(10): small business retirement exemption expressly preserved on pass-through of gain to shareholder).23 Of course, ‘streaming’ in the context of companies is often discussed. But streaming in the context of companies refers to the type of ‘tax characterised dividend’, namely: (i) an unfranked dividend; (ii) a partly franked dividend; or (iii) a fully franked dividend. Accordingly, streaming in the context of companies is not referring to directing certain types of gains made at the company level to certain shareholders.

23 ITAA 1936 s 109D(1)(b), (6).
24 ITAA 1997 s 202-75(3).
26 ITAA 1997 s 207-20(1).
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2.2 Beneficiary Derivation or Entitlements

2.2.1 Present Entitlement as mechanism for Allocation of Most Types of Taxable Income to Beneficiaries

Present entitlement is the current ‘entitlement’ concept that determines whether a beneficiary is taxed (or whether the trustee pays tax in their representative capacity for a beneficiary) on the one hand,\(^{28}\) as opposed to the trustee being the proper taxpayer in their representative capacity for the trust beneficiaries as a whole.\(^ {29}\) Subject to the reference below to a former ATO practice, the position is the same whether a fixed trust or discretionary trust is involved. There are three ways of establishing present entitlement, namely: (i) the case law notion\(^ {30}\) (ii) through a vested and indefeasible interest that falls short of the case law present entitlement concept\(^ {31}\) and (iii) allocation of trust profits by a trustee in exercise of their

\(^{28}\) There are three broad situations: (i) beneficiary taxation; s 97 of the ITAA 1936 (ii) trustee taxation on behalf of a beneficiary under a legal disability; s 98(1) and (iii) trustee taxation on behalf of a beneficiary who has a vested and indefeasible interest but is not presently entitled; s 98(2).

\(^{29}\) Secs 99, 99A.

\(^{30}\) Secs 97, 98.

\(^{31}\) Sec 95A(2).
discretion (s 101).\textsuperscript{32} The primary focus in this article is on the creation of entitlements under a discretionary trust.\textsuperscript{33}

There is no express rule in s 101 as to the time by which present entitlement must be established in order for beneficiary taxation to apply to the taxable income for an income year.\textsuperscript{34} On 20 May 1966, the ATO wrote a memo that became Taxation Ruling IT 328. IT 328 was withdrawn with effect from 1 September 2011. Paragraphs 31 and 32 of former IT 328 read as follows:

\begin{quote}
Period in which Application of Income Should be made

31. Where a trustee is carrying on a business, it will often be impossible to determine the amount of the net income of the trust estate until after the close of the year of income.

32. Enquirers may be told that, although a strict application of the law may possibly require that income be paid or applied
\end{quote}

\textsuperscript{32} An argument could be made that \textit{ITAA 1936} s 101 is not really required. The reason is that once a trustee of a discretionary trust exercises his/her discretion in favour of a beneficiary, this would seem to amount to present entitlement under the case law concept (assuming there is no deferred enjoyment built in to the profit allocation). If there were deferred enjoyment, one would think that \textit{ITAA 1936} s 95A(2) would then be satisfied if the case law notion of present entitlement were not satisfied.

\textsuperscript{33} In light of the decision in \textit{Colonial First State Investments Ltd v FCT} 2011 ATC 20-235 (see below), a post-30 June entitlement date may assist ‘fixed trusts’ to effectively ‘stream’ certain categories of gains to beneficiaries for income tax purposes. It is likely a post year-end entitlement rule will be implemented for trusts that come within the proposed MIT regime: see Board of Taxation, \textit{Review of the Tax Arrangements Applying to Managed Investment Trusts: A Report to the Assistant Treasurer} (August 2009), [5.27], ([5.41] (‘Managed Investment Trusts Report’).

\textsuperscript{34} Nor is there an express rule in the other present entitlement provisions, namely, \textit{ITAA 1936} ss 95A(2), 97.
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Prior to the close of the year of income if section 101 is to be relied on, it will be accepted that a payment or application made within two months of the close of the year of income is effective for purposes of section 101 – provided, of course, that the other requirements of the section are complied with and the assessments raised under section 97 or 98 are accepted. A longer period may be allowed for this purpose, on application being made to a Deputy Commissioner, if the amount of the net income of the trust estate cannot conveniently be determined within two months.

On 11 July 1980, the ATO wrote Taxation Ruling IT 329. Paragraph 11 read as follows:

Consistently with the directions given in paragraphs 31 and 32 of IT 328 it is accepted that a declaration, resolution, etc. which fulfils the above requirements made within two months after the close of the year of income will be effective for the purposes of section 101, i.e. it will be accepted as an application of the trust income in the year preceding the two months period.

The Asprey Report of 1975 said:

The trustee’s exercise of his discretion may be made at some time after the taking of the trust accounts for a year and will be treated by him [for trust law purposes] as having been made from the trust income of that year. As the law stands, it is not clear whether the effect is to deem the beneficiary presently entitled to a share of the income of the year in question.\(^{35}\)

This extract from the Asprey Report suggests the allocation or entitlement will be valid for trust law purposes, but that the position for income tax law is not clear.\(^{36}\)

\(^{35}\) Asprey Report, above n 2, [15.10]. There is no need to examine the case law that led the Asprey Report to make this ‘unclear law’ comment.

\(^{36}\) The reference to the trustee’s allocation after year-end being valid for trust law purposes implies that the requirements of the trust deed
In 2011, in the case of *Colonial First State Investments Ltd v FCT*, a case concerning an application for a private ruling where the relevant ‘fixed trust’ sought to change its trust deed to enable the ‘streaming’ of the trust’s discount capital gains to long term investors (beneficiaries) and non-discount capital gains to short-term investors, Stone J said:

I have concluded that, having regard to the manner in which, and the time at which, any part of the Redemption Amount is allocated to one or the other of the relevant accounts, and the fact that the allocation is in the discretion of the Responsible Entity [trustee], it is impossible to satisfy the Harmer requirement that the present entitlement arise within the relevant tax year.

Even though the trust involved in *Colonial First State Investments Ltd v FCT* was a fixed trust and that s 101 was not in issue, based on Stone J’s comments, it appears that the current law that applies to all three methods of obtaining present entitlement is that it must be established by 30 June. On 24 August 2011, and with effect from 1 September 2011, the ATO withdrew IT 328. Paragraph 11 of IT 328W – Notice of Withdrawal stated that as the ATO’s administrative practice (2 months after year-end at least) is contrary to the legislative requirement for present entitlement, IT 328 is accordingly, withdrawn. IT 329 was also withdrawn on 24 August 2011 for the same reasons as those given for IT 328. It is also noted that

are satisfied so as not to frustrate the validity of the allocation. Some discretionary trust deeds in 1975 may have required the creation of present entitlement by 30 June.

*Colonial First State Investments Ltd v FCT* 2011 ATC 20-235.

Ibid [38].

IT 328. One could ask why the ATO did not withdraw this ruling in 2006 after the decision in *Pearson v FCT* 2006 ATC 4352. In that case, Edmonds J said ‘First, “present entitlement” in terms of Division 6 of Part III of the ITAA has to be determined by the end of the year of income to which the income relates, in the sense of its year of
under the case law concept of present entitlement, a beneficiary may be presently entitled to income even though their precise entitlement cannot be ascertained before the end of the year.\textsuperscript{40} There is no reason to think this should not apply to a discretionary trust.

2.2.2 Retention of Character of Gains as they Pass-Through to Beneficiaries and Streaming of Gains to particular Beneficiaries

The terms ‘conduit income’, ‘retention of character of gains’ and ‘streaming of gains’ often are discussed together. The term, conduit income, is not that helpful and is discarded here.\textsuperscript{41} In the
current context, retention of character of gains refers to whether receipts or gains made by a trustee retain their character when passed-through to the beneficiaries entitled to such gains. Streaming refers to the selective allocation or directing of certain gains made at the trustee level, to particular beneficiaries. It is impossible to see how (effective) streaming can be achieved unless a gain retains its character on pass-through to a beneficiary. Accordingly, streaming of gains is dependent on retention of character of gains. It should also be noted that retention of character of gains and streaming are relevant to trust law (trust law profits) and tax law.

Putting aside the new regimes dealing with franked dividends and capital gains (see Sub-Part 2.3 below), it is fairly likely that retention of character of gains is widely accepted throughout the income tax.\(^\text{42}\) The retention of character of gains issue can also encompass the idea that the character of the trustee’s activity is or is not attributed to beneficiaries of the trust.\(^\text{43}\) The status of streaming of other types of gains under entity’ would be more appropriate, the term conduit income could mean solely that receipts made at a trust (trustee) level are not to be taxed in the hands of the trustee, but rather they should be taxed only in the hands of the beneficiaries.

\(^\text{42}\) See eg, \textit{Charles v FCT} (1954) 10 ATD 328,331. See also the recent Full Federal Court decision in \textit{FCT v Greenhatch} 2012 ATC 20-322 which effectively held that the old provisions dealing with discount capital gains of trusts (\textit{ITAA 1997} sub-div 115-C) did support the retention of character of gains on pass-through to beneficiaries. There is nothing in the High Court transcript dealing with the taxpayer’s application for special leave to appeal, that undermines this: \textit{Greenhatch v FCT} [2013] HCATrans 104 (10 May 2013).

\(^\text{43}\) See, eg, the averaging provisions for primary producers whereby beneficiaries of a trust may be treated as carrying on a primary production business (thereby gaining access to the income averaging provisions) where the trustee carried on a primary production business: \textit{ITAA 1997} s 392-20.
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current law is not clear and is likely to depend on the drafting approach adopted in the respective tax regime or provision dealing with pass-through of gains to beneficiaries.\textsuperscript{44}

2.2.3 Miscellaneous Rules Re Time by Which Beneficiary Entitlements must Accrue or be Notified

The brief point that needs to be made here is that in a number of areas of the income tax, there appears to be (and has been) a legislative understanding that valid and effective entitlements to trust law income for a particular financial year (income year) can be created within two months after the end of that income year. Alternatively, two months after year-end has been set as a timing rule in regard to the operation or non-operation of certain tax rules. The areas are:

(a) Sufficient continuity in pattern of distributions for trust loss usage. This test applies to discretionary trusts that are not fixed trusts.\textsuperscript{45} The rule sets a minimum threshold (more than 50%) for continuity of distributions in order that the trust can use prior year revenue losses as a deduction in future years.\textsuperscript{46} The point for present purposes is that a distribution to a particular beneficiary can be counted for a particular

\textsuperscript{44} The Full Federal Court in \textit{FCT v Greenhatch} 2012 ATC 20-322 held that the old provisions dealing with discount capital gains of trusts (\textit{ITAA 1997} sub-div 115-C) did not permit streaming of discount capital gains. The High Court rejected the taxpayer’s application for special leave to appeal to the High Court: \textit{Greenhatch v FCT} [2013] HCATrans 104 (10 May 2013).

\textsuperscript{45} In other words, we are dealing with discretionary trusts that have not elected to become a family trust under the income tax law. Given the tax advantages of being a family trust, it is very likely there are very few discretionary trusts that have not elected to be a family trust.

\textsuperscript{46} \textit{ITAA 1936} sch 2F ss 267-20, 267-30, 269-60, 269-65, 272-45.
income year provided the beneficiary is distributed profits within 2 months after the end of the income year;\(^47\)

(b) Notification of present entitlement to exempt entities. This recently introduced rule deems a beneficiary that is an exempt entity to not be presently entitled to trust profits where the trustee has failed to notify the exempt entity of their present entitlement within 2 months after the end of the relevant income year.\(^48\) The consequence of failing to meet the notification requirement is that the exempt entity will not be treated as the ‘proper taxpayer’ in spite of being (actually) presently entitled to the profits.\(^49\)

(c) Choice for trustee to be taxed on capital gain. This recently introduced rule confers a choice on the trustee of a resident trust to be taxed on a capital gain in their representative capacity provided that the property representing the gain has not been paid to or applied for the benefit of a beneficiary within 2 months after year-end.\(^50\) The trustee must make the choice within 2 months after year-end.\(^51\)

\(^{47}\) See the references to 2 months after the end of the income year in ss 267-30(1), 269-60 and 269-65(1)(a) in Schedule 2F to the ITAA 1936.
\(^{48}\) ITAA 1936 s 100AA(1).
\(^{49}\) The deemed ‘non-present entitlement’ means that a trustee liability (assessment) will be activated using the tax rates applicable to ss 99 or 99A.
\(^{50}\) ITAA 1997 s 115-230(3). The most obvious situation where a trustee may consider making this choice is where a particular beneficiary is not made specifically entitled to a capital gain, and therefore the capital gain would be taxed to the beneficiary that is presently entitled to the trust law income, at s 115-227(b). This would be unfair if the relevant profits are not going to be allocated to that beneficiary. The choice can provide relief from such unfairness.
\(^{51}\) Sec 115-230(5)(a). The ATO can allow the trustee more time to make the choice; s 115-230(5)(b).
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2.3 Share of Net Financial Benefit for ‘Franked Dividends’ and ‘Capital Profits’

From 1 July 2010 (2010-11 income year), new rules were introduced to ensure that franked dividends and capital gains of a trust could be streamed to particular beneficiaries. The government was concerned that, in light of the High Court decision in Bamford, that such streaming might not be permitted.52

Briefly, provided a beneficiary of a trust has a share of the net financial benefit (ie, trust law amount) that represents the dividend by 30 June (ie, entitled to cash dividend), for income tax purposes, that beneficiary will be allocated the cash dividend, the gross-up (assessable income inclusion) and the franking credit for the relevant income year. There is no express rule stating that the beneficiary’s entitlement must arise by 30 June. However, the trustee must have made a record of the beneficiary’s entitlement by 30 June,53 thereby effectively incorporating a 30 June deadline for the creation of entitlement. If the trustee fails to create an entitlement to the dividend by 30 June, the dividend, gross-up, etc, will broadly be allocated on a

52 As it turns out, this concern was justified. The Full Federal Court in FCT v Greenhatch 2012 ATC 20-322 held that a part of a discount capital gain could not be exclusively streamed for tax purposes to a particular beneficiary being the beneficiary to which the related trust profit was streamed under trust law principles (trust deed). This implied that part of the discount capital gain was allocated to beneficiaries to which the trust profit had not been streamed for trust law purposes. The High Court rejected the taxpayer’s application for special leave to appeal to the High Court; Greenhatch v FCT [2013] HCATrans 104 (10 May 2013).

53 Definition of ‘share of net financial benefit’ in ITAA 1997 s 207-58(1).
proportional basis to beneficiaries that are presently entitled to trust law profits.\textsuperscript{54}

With perhaps one significant qualification, the rule in regard to capital gains is essentially the same as that for franked dividends. Like dividends, there is no express time rule for entitlements. However, the trustee must have made a record of the beneficiary’s entitlement by 31 August.\textsuperscript{55} This leaves open the question as to whether an entitlement can be created by 31 August, or is the relevant date 30 June. There are arguments both ways. However, the issue may have limited practical significance in light of the fact that the ATO has issued a binding taxation determination stating that the correct date is 31 August.\textsuperscript{56}

\textsuperscript{54} Definitions of ‘adjusted Division 6 percentage’ and ‘Division 6 percentage’ in ITAA 1936 s 95(1) and ITAA 1997 ss 207-35(4), 207-37(1), 207-50(3), 207-55(4)(b)(i).
\textsuperscript{55} Definition of ‘share of net financial benefit’ in ITAA 1997 s 207-58(1).
\textsuperscript{56} Australian Taxation Office, Income Tax: Capital Gains: For the Purposes of Subsection 115-228(1) of the Income Tax Assessment Act 1997, Can a Beneficiary of a Trust Estate be Reasonably Expected to Receive an Amount of a Financial Benefit Referable to a Capital Gain Made by the Trust Estate in an Income Year if the Fact That the Capital Gain Was Made is Not Established Until After the End of the Income Year?, TD 2012/11, 6 June 2012, [4], [5], [31], [32]. There is no credible explanation supporting the ATO’s position.
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3. WHAT SHOULD BE THE DERIVATION RULE FOR BENEFICIARIES OF DISCRETIONARY TRUSTS?

3.1 Future Model for Taxing Trust Income: ‘Entitlement’ Criterion or ‘Distribution’ Criterion for Beneficiary Taxation

As part of its review for modernising the taxation of trusts, the government has rejected the possibility of taxing trusts like companies, which presumably means, subject to comments below, that a ‘distribution’ style derivation rule will not apply to a beneficiary in a discretionary trust.\(^57\) In addition, it seems to be accepted that trusts will be recognised as ‘flow-through vehicles’ and that the primary taxpayers will be the beneficiaries. Three models for taxing trusts have been put forward. They are (a) the Patch model\(^58\) (b) the proportionate within class model (now called the proportionate assessment model)\(^59\) and (c) the trustee assessment and deduction model (now called the economic benefits model).\(^60\)

Even though each model differs ‘slightly’, they are very similar in regard to their main structural features. All three models seek to tax all of the trust’s taxable income on a current basis (ie, no deferral is possible). Importantly, for current purposes, the patchwork model and the proportionate assessment model have an entitlement criterion for beneficiary taxation, just like the current present entitlement concept. The economic benefits model has a ‘distribution’ criterion for beneficiary taxation. However, even though this is a distribution

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\(^57\) Modernising the Taxation of Trust Income Report, above n 1, 2; Taxing Trust Income Report, above n 1, 7.
\(^58\) Modernising the Taxation of Trust Income Report, above n 1, 36-7.
\(^59\) Ibid 37-9; Taxing Trust Income Report, above n 1, 22-6.
\(^60\) Modernising the Taxation of Trust Income Report, above n 1, 39-42; Taxing Trust Income Report, above n 1, 16-21.
criterion, distribution here is not unlike an entitlement criterion because it still serves to identify the proper taxpayer between the beneficiary and trustee. And in any event, the only difference between an entitlement criterion and the distribution criterion is ‘discharge’ of an entitlement. Certainly, ‘distribution’ under the economic benefits model is quite unlike the distribution criterion under the company tax regime. Accordingly, this paper will refer to all three models under the current trust review as encompassing an entitlement criterion.

3.2 Options for Beneficiary Entitlement Timing Rule

There are essentially two options for the beneficiary ‘entitlement’ rule to support taxation of the beneficiary, even though the precise content of one of these options, by its nature, is open for further debate (sub-options). The first option is that entitlement must accrue or arise by 30 June (end of income year) in order that the relevant beneficiary becomes the proper taxpayer. This appears to be the law concerning present entitlement under the current trust taxation provisions.

61 Under the company tax regime, a distribution exposes the dividends to another taxing point, which is in addition to the taxing point inside the company when the company made taxable income. This is not the case under the proposed economic benefits model for trust taxation.

62 There is a third option, namely, the beneficiary must obtain an entitlement to particular gains at, or very close to, the time the trustee derives that related profit. This would be very contentious. The ATO made such a submission under the current law in Colonial First State Investments Ltd v FCT 2011 ATC 20-235, [31], but the court rejected the submission; at [32].

63 Ibid [38]. As noted in Sub-Part 2.2.1, the judicial support for this position does not provide strong supporting reasoning. It may be that the judiciary considers that a year-end entitlement rule is more consistent with the rest of the income tax ‘derivation’ rules.
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ATO regards this as the current law. Strangely, this option is not canvassed or contemplated in any meaningful way in the two discussion papers regarding the rewrite of the trust taxation provisions. Little in the way of explanation is given as to why this option is not seriously considered.

The second option, which can have various sub-options to it, is that entitlement can accrue by some specified time after the end of the relevant income year. The ATO practice (as set out in IT 328) for at least 45 years (1966-2011) was to permit a two month period after year-end within which the trustee could create present entitlement for a beneficiary. When IT 328 was written in 1966, the due date for lodgment of tax returns by trustees, whether carrying on a business or not, was two months after year-end. The due date for beneficiaries of a trust was also two months after year-end.

The Asprey Report recommended a three month period after year-end (30 September) within which a beneficiary of a discretionary trust could be made presently entitled to trust profits in order for beneficiary taxation to apply. No reasoning

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64 Australian Taxation Office, Decision Impact Statement, Colonial First State Investments Ltd v Commissioner of Taxation, 30 June 2011.
65 If a post year-end entitlement rule were adopted and there was a desire to take advantage of the rule, it is likely that many trust deeds would have to be amended to overcome the premature creation of present entitlements on 30 June by operation of a default vesting clause.
66 IT 328, [32]. It appears that IT 328 was issued as a memo to ATO staff on 20 May 1966, and therefore, there is some likelihood that the ATO’s two month practice was in place before the issue of IT 328.
67 Section 161 and Notice of Commissioner of Taxation in Commonwealth, Gazette, No 56, 30th June 1966.
68 Asprey Report, above n 2, [15.10]. It should also be noted that the Asprey Report also recommended giving the ATO discretion to treat the creation of present entitlement for a beneficiary after the three
was provided in support of this three month recommendation. At the time the Asprey Report was written, the due date for lodgment of tax returns by trustees, whether carrying on a business or not, was two months after year-end. The due date for beneficiaries of a trust was also two months after year-end.  

The latest discussion paper on options for the reform of the trust taxation provisions seems to favour a two month period after year-end (31 August) under both the economic benefits model and the proportionate assessment model. The ATO’s former administrative practice is the major thing pointed to as justification for the two month period. However, the latest discussion paper also canvasses entitlement dates after 31 August, for example, dates that coincide with the due date for lodgment of trusts’ tax returns.

The proposed regime dealing with managed investment trusts (MITs), now scheduled to start in July 2014, suggested a 3 month post year-end period for trustees to ‘attribute’ the MITs taxable income to beneficiaries.

For completeness, one commentator has suggested that the current law permits present entitlement to arise at any time (eg, month period as having been created within the three month period; at [15.10].

69 Section 161 and notice of Commissioner of Taxation in Commonwealth, Australian Government Gazette, No G25, 1 July 1975.
70 Taxing Trust Income Report, above n 1, 9. See also Consultation Question 2 at 13 and in Appendix C at 53, where the underlying premise of the question is that 31 August has been accepted (subject to further extension) as the date by which beneficiary entitlements can be created.
71 Modernising the Taxation of Trust Income Report, above n 1, 12.
72 Ibid 12-3.
73 Managed Investment Trusts Report, above n 33, [5.27(c)], [5.41].
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18 months after year-end). This is based on the idea that the entitlement rule under the current trust taxation provisions focuses on trust law principles, and that those principles allow present entitlement to arise at any time. Accordingly, this could also be considered a sub-option under the post year-end option.

3.3 Guiding Principle(s) for the Beneficiary Entitlement Timing Rule

Unless there is something unique about a discretionary trust and the circumstances of their beneficiaries that warrants different treatment, the timing rule for beneficiary taxation should be analogous to the timing rules that apply to taxpayers in regard to other charging provisions, and especially the charging provisions that apply to taxable income obtained through intermediaries. Inter-taxpayer equity would seem to demand this.

The starting point, outside of the discretionary trust situation, is that the income tax overwhelmingly requires an entitlement to have accrued to (for accrual type derivation rules) or paid to (for receipt type derivation rules) the taxpayer before 30 June in order for the related tax amount/item to enter assessable income for that income year. However, as pointed out in Sub-Parts 2.1.1 and 2.1.4, at times the income tax allows the level of assessable income (or deductions) for an income year in regard to an item to be determined or affected by a choice, election or similar, made after year-end. In regard to rollover elections, the choice goes further than just the level of assessable income, etc; the choice goes to the effective occurrence of a taxable event (ie, realisation). For the most part though, post year-end choices

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75 This is explained in Sub-Part 3.9 below.
usually deal with amounts rather than the fact that a taxable event has occurred within the income year. While post year-end choices are not small in number, the income tax takes this post year-end approach in fairly limited circumstances. And, it is usually in circumstances where the item or amount involved is likely to be a small component of the taxpayer’s tax base for the relevant income year. Certainly, the post year-end approach is not the accepted practice in regard to a ‘normal’ charging provision.

The accrual of entitlement by year-end is also the case in regard to the other two widely used intermediaries, namely, the partnership (for partners) and company (for shareholders). It is arguable that the trust vehicle is analogous to that of the partnership and company vehicle because of the use of pooled resources to obtain a return on investment. Therefore, it is arguable that these two latter vehicles provide a more relevant benchmark for the trust than that provided by the general derivation rules. For partnerships and companies, ‘entitlements’ that have not arisen before 30 June cannot enter the tax base of the taxpayer for that income year. Given this, equality of treatment would seem to require that the beneficiary’s entitlement in the discretionary trust situation should arise before or at 30 June in order for that beneficiary to ‘derive’ the related assessable amount.

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76 The closing trading stock valuation options provide an example of this. In particular, no matter which option is chosen, there will be a closing trading stock amount and therefore an amount against which to compare the opening stock figure with, but the amount may differ depending on the option used.

77 There is of course an air of unreality around the ideas of ‘pooled resources’ and a ‘return on investment’ when a discretionary trust is involved.
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3.4 Discretionary Trust situation as a Standard Tax Accounting Issue and/or Normal Matter of Identifying the Proper Taxpayer

3.4.1 Sufficient Time after Year-End to Determine Trust’s ‘Net Income’ and Beneficiary’s Allocation

The current support for a post year-end rule relies, in part if not solely, on the ATO’s former (45 year) practice. Accordingly, the former practice and its rationale may be instructive. Paragraphs 31 and 32 of former Taxation Ruling IT 328 provided the ATO’s justification. They are set out again here:

31. Where a trustee is carrying on a business, it will often be impossible to determine the amount of the net income of the trust estate until after the close of the year of income.

32. Enquirers may be told that, although a strict application of the law may possibly require that income be paid or applied prior to the close of the year of income if section 101 is to be relied on, it will be accepted that a payment or application made within two months of the close of the year of income is effective for purposes of section 101 – provided, of course, that the other requirements of the section are complied with and the assessments raised under section 97 or 98 are accepted. A longer period may be allowed for this purpose, on application being made to a Deputy Commissioner, if the amount of the net income of the trust estate cannot conveniently be determined within two months.

The reference to ‘net income’ in paragraph 31 could be to: (i) trust law income (profits); (ii) taxable income; or (iii) both trust law income and taxable income. While there is some doubt, it is submitted that the reference to ‘net income’ is to trust law income or trust law profits, rather than to taxable income. The
main basis for this is that the paragraph immediately following paragraph 31, namely, paragraph 32, is clearly dealing with the application of trust law income. Therefore, it appears that the two month concession (with the possibility of further extension) is grounded on the trustee not knowing the amount of trust profits by year-end. But, lack of knowledge of trust profits by year-end is also likely to be accompanied by lack of knowledge of taxable income by year-end. And in turn, these two ‘knowledge gaps’ means beneficiary profit allocations cannot be made with ‘precision’ by year-end, and taxable income allocations (assessable income to beneficiaries) cannot be made with precision by year-end.

The ATO’s (former) justification or premise is that the trust’s profit (and taxable income) for the year cannot be reasonably known by year-end; knowing or being able to determine profits and taxable income with accuracy appears to be the central thing. This lack of information about being able to measure profits by year-end is also mentioned in the two trust tax review consultative documents.\(^78\)

This need to know profits for the year with accuracy must be driven by the desire that the trustee can allocate a relevant portion of the profits to beneficiaries with accuracy. In other words, the real basis, or at least the effect, of the ATO’s (former) post year-end entitlement approach is that trustees should be able to determine, with precision, the profit allocation to each beneficiary (and in turn, assessable income) before the trustee is required to create an entitlement to trust profits. The ATO’s former ruling does not indicate why it is desirable to have such precision in measurement before a trustee is bound to create entitlements. Aside from references to the inflexibility and

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\(^78\) Modernising the Taxation of Trust Income Report, above n 1, 15, 33; Taxing Trust Income Report, above n 1, 12.
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administrative impracticality of a year-end rule, the two trust tax review consultative documents also do not state why it is desirable to have precision in measurement before a trustee is bound to create entitlements. The effect of a post year-end rule is that it also provides (more) time for the trustee to know the beneficiaries other financial situation (and in turn, other taxable income) for the relevant year before having to create entitlements, thereby further increasing the tax efficiency of discretionary trust allocations.

Lack of knowledge about the precise amount of assessable income or taxable income from an activity for an income year as at 30 June would be common to many taxpayers. And this lack of precision of measurement would not be restricted to businesses, but it would be businesses where a greater degree of lack of precision would be more common. No suggestion is ever made that such taxpayers should be able to enter into a transaction post year-end that will be taken into account for tax purposes for the income year just completed. But isn’t this what is being facilitated by a post year-end rule for entitlements under a discretionary trust; the beneficiary is obtaining an entitlement post year-end that is taken into account for tax purposes in the

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79 Modernising the Taxation of Trust Income Report, above n 1, 15; Taxing Trust Income Report, above n 1, 12.
80 It would be a fairly rare case where the trustee of a discretionary trust did not know or did not have the means of obtaining fairly accurate information about the financial position and the tax position of most potential beneficiaries of the trust before the end of a financial year.
81 It is interesting to note that, strictly, [31] and [32] of IT 328 seem to be restricted to discretionary trusts that are carrying on a business. However, the ATO has stated that the ‘[two month concession] has been applied to all trusts’; see Australian Taxation Office, Decision Impact Statement, Colonial First Investments Ltd v Commissioner of Taxation, 30 June 2011, n 1.
income year just completed. And, this circumstance is considered acceptable because the trust profits could not be measured with precision by year-end.

3.4.2 Tax Return Lodgment Date for Income Year as Derivation Timing Rule

Although not expressly stated, it is very likely that the two month entitlement leeway previously provided by the ATO in IT 328 was linked to the due date for lodging the tax returns of trustees and beneficiaries. This is also a significant point of discussion in the two consultative documents in regard to the rewrite of the trust tax provisions. There is also mention of a ‘compliance dividend’ associated with a post year-end date in the first consultative document.

In many cases, precise calculation of the trust’s taxable income for the income year will be delayed because of elections conferred on the trustee and some of these elections can be exercised as late as the time the trustee’s due date for their tax return lodgment. This can be as late as 4-10 months after the end of the income year. In some cases, the ATO has discretion to allow (even) further time to make particular elections.

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82 As pointed out in Sub-Part 3.2 above, when IT 328 was written, the due date for lodgment of tax returns of trusts and their beneficiaries was two months after year-end.

83 Modernising the Taxation of Trust Income Report, above n 1, 33.

84 *ITAA 1997*ss 40-130(1)(a) (choice to use prime cost method of depreciation or diminishing value method), 70-30(2) (choice on whether to use cost or market value as deemed consideration when item of taxpayer commence to be held as trading stock), 70-45 (choosing a valuation method to apply to items of closing trading stock on hand).

85 Secs 40-130(1)(b), in regard to choice between prime cost method of depreciation or diminishing value method, 70-30(2) in regard to choice on whether to use cost or market value as deemed consideration when item of taxpayer commences to be held as trading stock.
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While it is possible for a trustee to determine the taxable income before, at or soon after 30 June, many are likely to defer this task for some period after year-end. And, some trustees may delay the calculation until the last legally required moment for its determination (ie, lodge tax return), which could be as late as 10 months after year-end. Where this is the case, this also means that beneficiaries’ assessable income inclusions cannot be precisely ascertained until that time. This could have the effect of delaying lodgment of beneficiaries’ tax returns beyond the relevant lodgment date or requiring beneficiaries to lodge amended returns to correct for necessary estimates contained within returns lodged within lodgment times. Given the desire of many taxpayers to have timely assessments issued (sometimes to obtain refunds), this process may also require the issue of amended assessments, something that should be avoided.

The question is whether these matters or concerns provide reason(s) for setting aside the widely accepted year-end tax accounting rule in the discretionary trust situation? The answer given in the current trust tax rewrite consultative documents is a resounding yes. Again, while the former IT 328 does not expressly say so, the 2 month leeway (along with potential for further extension) stated in that ruling is likely to have been based on the tax return lodgment times for trusts carrying on a business and their beneficiaries.

Despite the ATO’s former position as articulated in IT 328 (now withdrawn) and the position and discussion in the recent trust tax rewrite review, it is very difficult to see how tax return lodgment times provides a basis for setting aside the normal tax accounting rule that is the basis for the annual tax period under the income tax. In particular, it is hard to see why the removal of ‘amount uncertainty’ in respect of chargeable tax gains to

86 Modernising the Taxation of Trust Income Report, above n 1, 33; Taxing Trust Income Report, above n 1, 12-3.
facilitate lodgment of tax returns ought to be addressed through changing what is otherwise a tax accounting rule that has virtual universal application. The removal of such ‘amount uncertainty’ can be addressed through a tax administration rule rather than changing a substantive tax base rule (approach) that has near universal application. After all, the lodgment of tax returns and associated matters is in the field of tax administration. For example, the law could allow extension of time for lodgment of tax returns until amounts became certain. If long tax return extensions are considered undesirable, the law could allow for amendments of tax returns along with the necessary issue of amended assessments. To avoid amended assessments having to issue, the law could allow for corrective adjustments in the following income year so that the tax return entry for the relevant income year is based on a bona fide estimate. This model is already used in other parts of the income tax.\footnote{A following income year corrective approach is taken in the case of the quantum of liabilities (estimated liabilities) incurred by insurance companies. In year one (year in which event insured against occurred), the insurance company will make a bona fide estimate of the amount of the liabilities it has incurred, and that becomes the deduction for year one. As the original liabilities are paid to, discharged with or settled with the insured person in future income years, the insurance company will either: (i) claim more of a deduction if original estimate was less than the ultimate payout or (ii) include an amount in assessable income if the original estimate was more than the ultimate payout: Australia and New Zealand Banking Group Ltd v FCT 94 ATC 4026, 4035. Indeed, an extra deduction could also be claimed in the year after the original year when it becomes obvious that the original estimate was understated: Commercial Union Assurance Company of Australia Ltd v FCT 77 ATC 4186, 4197.} In short, it is hard to see why a potential problem with the administrative aspects of the income tax ought to be addressed through changing a substantive tax accounting rule or the widely adopted approach to tax accounting.
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It is also worth querying the premise inherent in the tax return lodgment date debate. Aside from a special situation, the earliest possible time any taxpayer can be asked to submit their tax return is 31 October. Given the commercial incentive for any ‘business’ or ‘economic activity’ to know its performance for a period as soon as possible after the period ends, is it not likely that many trusts will have constructed financial accounts (eg, income statement) fairly soon after year-end? In addition, given that it is likely to be cost effective for many businesses to construct their taxable income position at the same time as determining their accounting position, is it not likely that many trusts will know their taxable income position before 31 October? In this regard, the taxpayer elections that can be made up until a certain date after year-end can be made earlier than the latest time stipulated in the tax law. In short, the premise that supports tax return lodgment time as the derivation rule is, to be generous, doubtful.

It should be noted that the post year-end leeway given to beneficiaries of discretionary trusts is not given to partners in a partnership and shareholders in a company. It is true that partners in a partnership are able to vary their assessable income allocation through an assignment of part of their interest in the partnership but this must be done before year-end to be effective for the relevant income year. Just like the discretionary trust situation, the ‘partnership’ and the partners are unlikely to know with precision the amount of profits and taxable income for the year at 30 June. Yet, there is no rule in the income tax and no ATO practice and no suggestion made that this lack of

88 ITAA 1936 ss 162 and 163 seem to empower the ATO to request a taxpayer to lodge a tax return for a period or part of a period by a time that is before the usual return lodgement times.
knowledge in the partnership context ought to be addressed through a change to the applicable tax accounting rule.\(^89\)

### 3.4.3 Receivable Uncertainty compared to Receivable Certainty with Amount Uncertainty

Another way to look at the ‘demand for measurement precision’ argument is through the ‘receivable uncertainty-receivable certainty with amount uncertainty’ dichotomy. Even though not expressly stated or expressed in this manner, it is suggested that the income tax often makes a distinction between ‘receivable uncertainty’ and ‘receivable certainty with amount uncertainty’; the former refers to uncertainty that a receivable (entitlement) will arise (at all) to the taxpayer, and the latter refers to the situation where it is clear that a receivable has arisen to the taxpayer, but that the amount that will be received is not clear.\(^90\) The current case law and the legislation deny a ‘derivation’ occurring where ‘receivable uncertainty’ is present.\(^91\) However, there is generally a derivation where there is ‘receivable certainty with amount uncertainty’. It is submitted that the options to value closing trading stock on hand is one example of receivable certainty with amount uncertainty.\(^92\)

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\(^{89}\) It should also be noted that the ATO requires variations to partner salaries (priority profit allocations) to be finalised before the end of the relevant income year in order to be effective for tax purposes for the year: see Australian Taxation Office, Income Tax: The Taxation Implications of ‘Partnership Salary’ Agreements, TR 2005/7, 25 May 2005, [10], [26].

\(^{90}\) These two terms are an adaptation of the terms ‘liability uncertainty’ and ‘amount uncertainty’ used in the context of dealing with uncertainty in regard to the deductibility of expenditures in G S Cooper, R E Krever and R J Vann, Income Taxation: Commentary and Materials (The Law Book Company Limited, 1989) 546.

\(^{91}\) BHP Billiton Petroleum (Bass Strait) Pty Ltd & Anor v FCT 2002 ATC 5169 provides an example of this.

\(^{92}\) The idea here is that a taxpayer with trading stock must have a closing value for trading stock, and therefore will effectively derive the closing value with certainty, but that the precise amount of that closing
Another example is a partner’s allocation of the partnership’s taxable income. 93

Requiring a year-end entitlement rule would (or could) attract the description of ‘receivable certainty with amount uncertainty’ in many discretionary trust (and fixed trust) situations. It is hard to see how this situation would differ in a material sense from the ‘receivable certainty with amount uncertainty’ that applies to many taxpayers outside the discretionary trust. Indeed, just about every taxpayer that operates a business (and many non-business taxpayers) would be faced with some degree of receivable certainty with amount uncertainty as at 30 June. No suggestion is ever made that the normal tax accounting rules ought to be changed to address this uncertainty. Having a year-end rule for beneficiaries of discretionary trusts would be characterised as receivable certainty with amount uncertainty as at 30 June.

3.4.4 Beneficiary has little or no Control over Accrual of Entitlement

From a legal perspective (but most probably not from a practical perspective), a beneficiary in a discretionary trust has little or no control over the accrual of an entitlement to the profits of a discretionary trust; the accrual of the entitlement is at the complete discretion of the trustee. For most receipts, covered by the income tax rules, taxpayers do have some if not considerable control over the accrual of a receivable. Is this sufficient reason to depart from the normal tax accounting rule?

stock will not be known (amount uncertainty) until the taxpayer makes the choice amongst the various options available to him/her.

93 A partner in partnership will know as at 30 June that if the partnership has taxable income for the income year, the partner will include an amount in assessable income. This is in spite of the strong probability that the partner will not know the amount of assessable income for some time after year-end.
The answer should be no. In principle, the degree of control over, or for that matter, the degree of security over the accrual of an entitlement should not be a basis for undermining the normal 12 month tax accounting period rules. Further, under current tax accounting rules, there is no support for variation to the normal tax accounting rules where taxpayers obtain unexpected income receipts (eg, involuntary payment that is a product of a taxpayer’s personal exertion). In an area analogous to a discretionary trust, namely, dividend payout under a discretionary dividend share (in a company), there is no suggestion that the normal tax accounting rule should not apply.

3.5 Discretionary Trust ‘Entity’ as an Earning and Division of Collective Profits

For many discretionary trusts, like fixed trusts, the situation will be one where a number of ‘participants’ share in a pool of profits from an economic activity. The position is the same in a partnership and a company. In the partnership situation, it is true that the proportional entitlements of each partner to the collective profits are set in advance (eg, 40% to partner A), rather than being at the discretion of the trustee, as is the case with a discretionary trust. However, the trustee is still dividing the collective profits amongst recipients that share in the collective profits. In the partnership situation, the partner entitlement accrues or is derived as at 30 June. That is, it is the partners’ positions as at 30 June that determines partners’ profits, and therefore allocation of taxable income. There is no scope for any post year-end decision or transaction to change the allocation (eg, an assignment of a share in the partnership

94 Sometimes called a dividend access share. These are shares in a company that do not automatically entitle the holder to dividends declared by the company. Instead, a holder of a dividend access share is only entitled to a dividend on those shares if the directors expressly declare a dividend in regard to those shares.
cannot affect (reduce) the assignor partner’s allocation under s 92(1)).

In the company situation for ordinary dividends, the derivation rule for shareholders - those who share in the pool of profits of the company – is the receipt of a dividend. The shareholders’ receipt of dividends marks the sharing of the company’s collective profits. There is generally no scope for a decision, whether by the company or the shareholder, made after 30 June to change the level of dividends the shareholder has derived by year-end. Two slight qualifications to this relate to the ability to prevent a deemed dividend arising through repayment of a loan after year-end and the attachment of franking credits to a dividend after year-end in a private company situation.95 But these two qualifications are limited to very particular circumstances and they do not undermine the general approach. Importantly, those two situations are quite unlike the obtaining of a ‘normal’ allocation of profits from the relevant entity.

It is true that a company will usually know the level of its profits, with precision, at the time it is considering its dividend distribution policy because it is distributing last year’s profits. Where a year-end entitlement rule is insisted on, the trustee would be considering its proportional distributions amongst beneficiaries without knowing the level of profits with precision. This in turn may mean that beneficiaries’ allocation of taxable income may not be able to be determined with precision, whereas in the company situation, this will be the case. Putting this aside, it is hard to see why a year-end rule should not also apply in the trust (discretionary trust) context. The fact that in the trust situation there is collective representative taxation where allocations are not made to specific beneficiaries cannot

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95 See Sub-Part 2.1.4 for an outline of these two rules.
be a reason for differential treatment. Taxation of ‘retained profits’ in a company is not distinguishable from this in any event because a distribution of profits by a company effectively means that the profits are taxed in shareholders’ hands, and not the company’s hands.\textsuperscript{96}

\subsection*{3.6 Tax Law ought to Respect Trust Law Entitlements}\textsuperscript{97}

Subject to the terms of a particular trust deed, it can be accepted that a valid exercise of a trustee’s power to appoint income of a particular year to a beneficiary after year-end is effective to allocate the trust’s profits for that year to the beneficiary under the general law.\textsuperscript{98} The idea here is that the tax law ought to fully respect this position. The argument goes that because trust law considers the beneficiaries as the beneficial owners of the relevant profits for the year, the tax law ought to adopt this and thereby allocate the relevant taxable income for that year to those beneficiaries. After all, it is strongly arguable that the tax law seeks to tax the beneficial owners of economic gains, and the beneficiaries are the economic owners of the gains made, even though their ownership entitlement only became apparent after year-end.

\textsuperscript{96} There are two types of dividend distributions by companies, unfranked and franked. Unfranked dividends are supported by profits that have not been taxed and therefore, there is no company level tax on these profits. A franked dividend is supported by profits that have been (initially) taxed at the company level. However, the gross-up and credit mechanism that operates at the shareholder level on receipt of dividends mean that these profits are effectively taxed at the shareholder level. Accordingly, only retained profits representing taxable income are taxed at the company level.

\textsuperscript{97} This issue is also relevant to the discussion in Sub-Part 3.9 below.

\textsuperscript{98} The trust law cases cited in Robertson, above n 74, certainly support this. Certainly, the writers of the Modernising the Taxation of Trust Income Report, above n 1, 33 also consider this to be the position.
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The argument appears to have some merit but on closer examination, it is not persuasive. First, the universally accepted idea under tax accounting rules is that in order for a tax amount from a transaction to be counted for an income year, the non-tax amount from the transaction must accrue to the taxpayer before year-end. The non-trust taxation charging provisions (eg, s 6-5) do not expressly make this distinction, but it is necessarily present. The trust taxation provisions seem to be the only charging provision(s) in the income tax where the distinction between: (i) the non-tax character and amount of a transaction (trust law/commercial law and accounting); and (ii) the tax character and amount of the transaction, is expressly and clearly delineated. That is, entitlement to a commercial gain under the trust tax provisions expressly dictates the derivation of assessable income. The short point is that the distinction between the commercial law aspects of a transaction and the tax law aspects of the transaction is present in all circumstances, and the non-tax law aspects of transactions do govern the tax law outcome from the transaction. And whether this is made explicit (trust tax provisions) or implicit (most other charging provisions of the income tax) in tax legislation should be irrelevant to the tax accounting issue.

The response could be that, by expressly making the tax allocations dependent on the trust law profit allocations, the intent of the parliament is that the normal tax accounting approach should be set aside so that entitlements per se govern the tax allocation. The problem is that this implies that entitlements could be created some 12 months, two years or even five years after year-end, and the expectation would be that the tax law should respect this. Acceptance of this would tend to undermine the annual tax period and the associated tax accounting rules under the income tax.
Secondly, the question under the income tax is not about establishing beneficial ownership of profits, receipts, and the like per se. Rather, it is submitted, the question is about establishing beneficial ownership by a certain time. The latter is inherent in the annual tax period and the associated tax accounting rules. Thirdly, acceptance of the after year-end argument leaves the income tax open to similar claims, especially in the area of collective income situations. Whether or not taxpayers come forward or are coming forward or have previously come forward with such requests is not relevant; the question is whether a claim could be credibly rejected in light of a post year-end rule for discretionary trusts.

3.7 Beneficiary Derivation Date and Trustee’s Fiduciary Duty to Beneficiaries

The assertion here is that the trustee of a discretionary trust should not be put in the position where he or she is making allocations of trust profits to beneficiaries without full knowledge of potential beneficiaries’ other financial and income circumstances for the financial year. It is argued that by requiring the trustee to make profit allocations by 30 June, the trustee is unlikely to have full information regarding the beneficiaries other financial position. By allowing the trustee some time after year-end to establish entitlements, it is more likely the trustee will have fuller knowledge of beneficiaries other financial position for the relevant year so that in exercising their discretion, trustees are better able to fulfill their duty to beneficiaries.

The assertion has some attraction because, as a matter of logic, the passing of time can reveal the other income or financial position of beneficiaries. Because of this, it would be easier for the trustee to discharge the trustee’s duty to beneficiaries, namely, by having fuller information about the
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financial circumstances and needs of the potential beneficiaries, thereby allowing appropriate allocations to be made.

However, for many discretionary trusts, there is of course, an air of unreality about the assertion. It is pretty well accepted that for many discretionary trusts, the allocations of trust profits has very little to do with the desire to know the other financial position of potential beneficiaries for the purpose of properly and fairly providing for them. Instead, allocations are often made on the basis of attracting the lowest possible income tax liability to the trust’s (collective) taxable income. This aim focuses on the taxable income allocations, and not the allocations of trust profits. It is true though that where the trust profits are similar in amount to taxable income, the effect of the focus on taxable income is that the trust profit allocations will roughly represent profit allocations. This is however undermined by the fact that many profit allocations are simply loaned back to the trustee (unpaid present entitlements), which suggests the beneficiary is not in need of the funds represented by the profit allocation that was made. Allocations to so-called ‘bucket company’ beneficiaries, also tends to undermine the trustee duty argument.

In any event, a year-end timing rule does not preclude the trustee from ascertaining fairly reliable estimates from beneficiaries about their other income and expenses. And, it can hardly be asserted that this imposes an onerous duty on trustees. In any event, trustees have to discharge their duties to beneficiaries as best they can within the constraints of the legal

99 One only needs to look at the allocations (or purported allocations) made and the relevant tax rate schedules at the time in some cases that have come before the tax tribunals to see evidence of this: East Finchley Pty Ltd v FCT 89 ATC 5280; Faucilles Pty Ltd v FCT 90 ATC 4003; Hasmid Investments Pty Ltd & Ors v FCT 2001 ATC 2150; FCT v Bamford & Ors; Bamford & Anor v FCT 2010 ATC 20-170.
framework, and it is hard to see why the ‘constraints’ imposed under the tax accounting rules of the income tax should not be seen as just another part of the legal framework.

3.8 Two Months after Year-End Rule Required because Current Law Assumes such a Rule

As noted at Sub-Part 2.2.3, there are a small number of areas of the current income tax where an operative rule assumes that the beneficiary can become presently entitled to the profits of a trust for an income year within 2 months after year-end and be an effective allocation of the relevant taxable income for income tax purposes. In the short term, there is no reason to think that these provisions will be changed. The question then becomes, does the continued existence of these provisions necessitate a derivation date of 2 months after year-end under the general trust tax provisions? The answer is no. Even though these provisions are related to and/or adopt the present entitlement concept, the operation of these provisions is not undermined by a year-end entitlement rule under the trust tax provisions.

3.9 Transparency of Discretionary Trust and Trust Law View of Discretionary Trusts as basis for Guidance on Entitlement Timing Rule

3.9.1 Transparency of Discretionary Trust

The trust vehicle is often described as a transparent entity or a flow-through vehicle. Transparency has a trust law dimension and a tax law dimension. The tax law does not necessarily have to adopt the trust law position (eg, position under the trust deed). The government can adopt a range of design features for taxing income obtained through an entity or intermediary, and some of these features are readily identified with the transparency description but others are not. The

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100 Taxing Trust Income Report, above n 1, 10.
important point though about transparency is that a high degree of it provides a basis for identifying gains, receipts, etc, made by the trustee with beneficiaries. A low degree of transparency points to little identification of gains made by the trustee with beneficiaries. Another way to put it is that a high degree of transparency indicates assimilation of trustee with beneficiaries, and a low degree of transparency indicates separateness between trustee and beneficiaries. If gains are identified with beneficiaries, then in spite of the ‘retrospective’ nature of trustee discretions, the gains can be viewed as having been made by beneficiaries (directly) during the financial year/income year (ie, the time the trustee made the gain). And accordingly, even though the trustee allocates profits after year-end, it may be appropriate to treat the beneficiary as having made the profits before year-end for both trust law and tax law.

It is suggested that there are two criteria (or three) by which to judge whether there is a high or low degree of transparency. They are: (i) retention of character of gains on pass-through to beneficiaries; and (ii) claw-back of tax-preferred income on distribution to beneficiaries. The third aspect may be the streaming of gains to particular beneficiaries.

There will be a high degree of transparency if the gain made by the trustee in their representative capacity retains its character on pass-through to a beneficiary. Briefly, either by express provision or by implication, most discretionary trusts will provide for character retention on pass-through of gains. And, the tax law, for the most part, will follow this. Importantly, it seems that whatever model emerges in the rewrite of the trust
tax provisions, retention of character of gains will feature heavily for many, if not all, types of gains.\textsuperscript{101}

Claw-back of tax-preferred income, in the context of discretionary trusts, refers to the situation where profits that were not represented by taxable income due to the tax system giving more favourable treatment to transactions, events, etc, than the accounting rules at the trust level, are taxed in the hands of the beneficiary on distribution. Claw-back can take the form of taxing the distribution on receipt, or instead not taxing the distribution but reducing the cost base of the beneficiary’s interest by the tax-free amount. Lack of claw-back occurs where neither of the two mechanisms mentioned, or any other mechanism, reverses the tax-preferred income status of the distribution on payout to a beneficiary. Put shortly, the presence of claw-back tends towards a low degree of identification between gains, receipts, etc, made by the trustee with beneficiaries. The absence of claw-back tends towards a high degree of identification between gains, receipts, etc, made by the trustee with beneficiaries. The current position re discretionary trusts is that there is no claw-back of tax-preferred income, either through taxation of the distribution,\textsuperscript{102} or cost base reduction.\textsuperscript{103} And, it seems that whatever model emerges in the rewrite of the trust tax provisions, this position will not change.

\textsuperscript{101} See Modernising the Taxation of Trust Income Report, above n 1, 33; Taxing Trust Income Report, above n 1, 9, 10, 20-1 (economic benefits model), 24-5 (proportionate assessment model).
\textsuperscript{102} ITAA 1936 s 97 cannot apply, and the ATO apparently has a practice of not applying ITAA 1936 s 99B where the income has an Australian source; see the comments of Hill J in Traknew Holdings Pty Ltd v FCT 91 ATC 4272, 4284 for a discussion of the reach of ITAA 1936 s 99B. The facts in Howard v FCT 2011 ATC 20-298 where the court applied ITAA 1936 s 99B, involved a non-resident trust estate.
\textsuperscript{103} Even if CGT event E4 could apply, the ATO has determined that it will not apply to a beneficiary in a discretionary trust: see Australian
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In regard to streaming of gains, it is submitted that the streaming issue carries significantly less weight, if any at all, than the other two issues in regard to identifying trustee gains with beneficiaries. However, it is arguable that the presence and toleration of streaming more closely identifies the trustee’s gain with beneficiaries compared to the absence of streaming. The reason is that the absence of streaming is treating the beneficiaries as ‘joint owners’ of each gain, whereas the presence of streaming gains may enable beneficiaries to be treated as ‘sole owners’. Under current law, aside from franked dividends and capital gains, there is uncertainty as to what types of gains can be streamed. It seems though that whatever model emerges in the rewrite of the trust tax provisions, streaming is likely to apply to most types of gains.104

3.9.2 Trust Law View of Discretionary Trusts

Robertson, in his 1996 article, Discretionary Trusts: An Illusory Problem, makes the following point:

That is why, as a matter of trust law, when the trustees exercise their discretion, that is taken to be the completion of the gift by the settlor, taking effect from the time of the settlement, not the time the appointment is made.105

And, a little later:

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104 See Modernising the Taxation of Trust Income Report, above n 1, 16, 38-9 (proportionate assessment model), 41 (economic benefits model); Taxing Trust Income Report, above n 1, 9, 10, 20-1 (economic benefits model), 24-5 (proportionate assessment model).

105 Robertson, above n 74, 26.
Thus, it is as if the settlor left a blank as to which discretionary beneficiary (or the takers-in-default) is entitled each year to the income for that year. The trustees are just filling in the blank, as if they were the settlor.106

Robertson cites and quotes from a United Kingdom and an Australian case in support of the contention.107 There is no need to examine the correctness of Robertson’s analysis; with respect, it is accepted for the purpose of this article. Accordingly, the point seems to be that for trust law purposes, the discretionary beneficiary becomes entitled, as matter of law, to their profit allocation during or before the relevant financial year. And, this is in spite of the fact that the trustee exercised the discretion to appoint the profits after year-end.

3.9.3 Comment

The combination of the retention of character of gains and the absence of claw-back of tax preferred-income along with the retrospective nature of beneficiaries’ entitlements provides some support for a post year-end entitlement rule. (The tolerance of streaming of gains also tends to better identify the gain with the individual beneficiary). The reason is that retention of character and absence of claw-back is effectively ignoring the presence of an intermediary so that, in effect, the beneficiary can be viewed as having made the gain directly. And, the retrospective nature of beneficiaries’ entitlements under trust law provides further support for a post year-end entitlement rule.

In spite of this, the support is not strong. First, and as stated earlier, the tax law does not automatically adopt the non-tax law view of a transaction. In this area, adoption of the trust law position without qualification would mean present entitlement

106 Ibid.
107 The cases cited and/or quoted from are: (i) Adamson v Attorney-General [1993] AC 257; and (ii) Queensland Trustees Limited v The Commissioner of Stamp Duties (1953) 88 CLR 54.
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could be created well into the future following an income year. It is hard to see how the annual tax period and the associated tax accounting rules can be maintained while accepting this position. Secondly, while the trust law position is accepted here (settlor or testator is making the gift to beneficiaries and trustee is merely completing the gift), that position defies reality. The reality is that the trustee, through the exercise of their power to appoint profits, is the source of beneficiaries’ financial entitlement. Prior to that event, the beneficiary as a matter of practicality (and law) had nothing but a mere hope of getting profits. And, an analysis that accepts a backdating of a gift to a time before the gifted amount comes into existence, which appears to be the trust law position, stretches a fiction considerably and is hardly a basis on which to base tax liabilities.

Thirdly, while retention of character of gains supports some degree of identification of the gain with the beneficiary who ultimately obtains the gain, the inescapable reality is that at the time the trustee made particular gains during the income year, not one beneficiary could be identified with that gain until the trustee exercises their power to appoint profits. Nothing analogous to a principal-agency relationship exists at the time the gain is made by the trustee. The best that can be said is that the trustee represents (or is an agent for) the general body of discretionary objects at the time the gain is made. This does not identify a gain with a particular beneficiary/taxpayer, which is what is required of an agency type situation in order to conclude the gain has accrued to a beneficiary by year-end under a normal tax accounting rule.

4. CONCLUSION

The working assumption in many parts of the tax profession, and, at the very least previously in the ATO for a considerable
period, is that trustees of discretionary trusts ought to be given time after year-end within which to create beneficiary entitlements to support beneficiary taxation. Treasury also seems to accept the assumption as well. This article examined both the reasons put forward from time-to-time in support of the post year-end rule (eg, time permitted so that the trust’s profits, taxable income, etc, position can be determined with precision, time permitted so that accurate tax returns can be lodged by their due dates) and other reasons that could be cited in support of a post year-end rule. The conclusion of the article is that the reasons in support of a post year-end rule have very little persuasive force. Further, when an equity analysis is undertaken of a post year-end rule vis-a-vis the year-end derivation rule that applies in both the direct derivation of income situation and through partnerships and companies, a post year-end rule for beneficiaries of discretionary trusts seems inequitable.

Even though the ATO withdrew its two month post year-end practice in light of the decision in Colonial First State Investments Ltd v FCT 2011 ATC 20-235 [38], that withdrawal was not based on a rejection of the original reason behind the two month post year-end practice, namely, ‘The practice was introduced because of difficulties trustees encountered in calculating, by year end, the amount of business income available for distribution to beneficiaries’; Australian Taxation Office, Decision Impact Statement, Colonial First State Investments Ltd v Commissioner of Taxation, 30 June 2011. Instead, the ATO’s withdrawal of the two month post year-end practice seems to be based purely on the strict application of the law as articulated by the courts: see Australian Taxation Office, Trusts: Interpretation of Section 101 in Relation to Sections 99 and 99A under 1964 Amending Legislation, IT 328W – Notice of Withdrawal, 24 August 2011, [11].