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THE PARLIAMENT OF THE COMMONWEALTH OF AUSTRALIA

HOUSE OF REPRESENTATIVES

TAX LAWS AMENDMENT (2011 MEASURES No. 5) BILL 2011

EXPLANATORY MEMORANDUM

(Circulated by the authority of the
Deputy Prime Minister and Treasurer, the Hon Wayne Swan MP)

Table of contents

Glossary 1

General outline and financial impact 3

Chapter 1 Primary producers' income averaging and farm management deposits 7

Chapter 2 Interim changes to improve the taxation of trust income 17

Chapter 3 National Rental Affordability Scheme 91

Chapter 4 Phasing out the dependent spouse tax offset 111

Chapter 5 Reform of the car fringe benefits rules 123

Glossary

The following abbreviations and acronyms are used throughout this explanatory memorandum.

Abbreviation	***Definition***
AEST	Australian Eastern Standard Time
ATO	Australian Taxation Office
ATO ID	Australian Taxation Office Interpretive Decision
Board	Board of Taxation
CGT	capital gains tax
Commissioner	Commissioner of Taxation
DSEWPaC	Department of Sustainability, Environment, Water, Population and Community
FBT	fringe benefits tax
FMDs	farm management deposits
ITAA 1936	*Income Tax Assessment Act 1936*
ITAA 1997	*Income Tax Assessment Act 1997*
kms	kilometres
MIT	managed investment trust
NRAS	National Rental Affordability Scheme
NRAS Act	*National Rental Affordability Scheme Act 2008*

General outline and financial impact

Primary producers' income averaging and farm management deposits

Schedule 1 to this Bill amends Divisions 392 and 393 of the *Income Tax Assessment Act 1997* (ITAA 1997) to allow trust beneficiaries to continue to use the primary production averaging (income averaging) and farm management deposits (FMDs) provisions in an income year where the trust does not have any trust law income (trust income) to which a beneficiary can be presently entitled (for example, because the trust has a loss for trust law purposes).

Date of effect: These amendments, which are favourable for taxpayers, apply where the income year of the trust is the 2010-11 income year or a later income year.

Proposal announced: This measure was announced in the Assistant Treasurer and Minister for Financial Services and Superannuation's Media Release No. 025 of 16 December 2010.

Financial impact: Nil.

Compliance cost impact: Nil to low.

Interim changes to improve the taxation of trust income

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

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

Date of effect: This measure applies for the 2010-11 income year and later income years.

The Government is implementing a Board of Taxation recommendation that the measure apply from the start of the 2010-11 income year. This provides certainty for taxpayers following the withdrawal of relevant public rulings and practice statements of the Australian Taxation Office with effect from the 2010-11 income year. This measure is generally beneficial to taxpayers.

Proposal announced: This measure was announced in the Assistant Treasurer and Minister for Financial Services and Superannuation's Media Release No. 052 of 13 April 2011.

Financial impact: The financial impact of this measure is unquantifiable but is expected to be small over the forward estimates period.

Compliance cost impact: Low. This measure only impacts upon those trusts that stream capital gains or franked distributions (including any attached franking credits) to specific beneficiaries. There is however an ongoing compliance cost impact and a low transitional impact, reflecting the need for taxpayers to be aware of the amendments, specifically the new specific anti-avoidance rules.

National Rental Affordability Scheme

Schedule 3 to this Bill addresses several technical issues which have arisen from the interaction between the tax law and the *National Rental Affordability Scheme Act 2008* and the associated regulations.

These amendments also simplify the operation of the National Rental Affordability Scheme (NRAS) for participants and provide some additional flexibility to NRAS participants in how the incentive is shared between members of consortiums participating in the NRAS.

Date of effect: The amendment to the treatment of state and territory NRAS-related payments applies from the 2008-09 income year. The amendments providing for an optional election apply from the 2010-11 income year. The remaining amendments apply from the 2009-10 income year.

The provision will apply retrospectively for the benefit of affected taxpayers.

Financial impact: This measure does not have any formal financial impact as it is designed to ensure the NRAS incentives are received tax-free by participants in the scheme, as was originally intended.

Compliance cost impact: This measure is expected to reduce compliance costs for affected taxpayers.

Phasing out the dependent spouse tax offset

Schedule 4 to this Bill amends the *Income Tax Assessment Act 1936* to implement the 2011-12 Budget measure to phase out the dependent spouse tax offset.

Date of effect: 1 July 2011.

Proposal announced: This measure was announced in the 2011-12 Budget and in the Treasurer's Media Release No. 047 of 10 May 2011.

Financial impact: This measure will have a revenue gain of $755 million over the forward estimates period.

2011-12	***2012-13***	***2013-14***	***2014-15***
$60m	$220m	$230m	$245m

Compliance cost impact: Low.

Reform of the car fringe benefits rules

Schedule 5 to this Bill amends the *Fringe Benefits Tax Assessment Act 1986* to reform the current statutory formula method for determining the taxable value of car fringe benefits by replacing the current statutory rates with a single statutory rate of 20 per cent, regardless of kilometres travelled.

Date of effect: These amendments will apply to commitments made after 7:30 pm, Australian Eastern Standard Time (AEST) on 10 May 2011 and be phased in over four years.

Existing contracts will be grandfathered and therefore subject to existing arrangements.

Proposal announced: This measure was announced in the 2011-12 Budget and in the Treasurer's Media Release No. 050 of 10 May 2011.

Financial impact: The reforms have the following fiscal impact over the forward estimates:

2010-11	***2011-12***	***2012-13***	***2013-14***	***2014-15***
$5m	$29.4m	$140.4m	$331.2m	$455.9m

Compliance cost impact: Ongoing — low.

Chapter 1
Primary producers' income averaging and farm management deposits

Outline of chapter

1.1 Schedule 1 to this Bill amends Divisions 392 and 393 of the *Income Tax Assessment Act 1997* (ITAA 1997) to allow trust beneficiaries to continue to use the primary production averaging (income averaging) and farm management deposits (FMDs) provisions in an income year where the trust does not have any trust law income (trust income) to which a beneficiary can be presently entitled (for example, because the trust has a loss for trust law purposes).

1.2 All the legislative references in this chapter are to the ITAA 1997 unless otherwise specified.

Context of amendments

1.3 On 16 December 2010, the Government announced that it would introduce amendments to the income tax law so that trust beneficiaries can continue to use the income averaging and FMD provisions in a loss year.

Primary producers' income averaging

1.4 The averaging provisions for primary producers smooth out the income tax liability of eligible individuals from year to year. Broadly, this is achieved by providing a tax offset to a taxpayer where their income is higher than average or requiring them to pay extra income tax where their income is lower than average.

1.5 To be eligible for income averaging a taxpayer must (among other things) be an individual who carries on a business of primary production in Australia for two or more years in a row. A beneficiary is taken to carry on a primary production business carried on by a trustee of a trust during an income year if they are presently entitled to all or part of the trust income for that year (subject to a specific anti-avoidance rule designed to prevent exploitation of the averaging rules).

Farm management deposits

1.6 FMDs are a mechanism for primary producers to hold over income from years of good cash flow (deferring the payment of tax on these amounts) and draw down on it in years when additional cash flow is required. Broadly, this is achieved by allowing the primary producer a deduction for the amount of an FMD in the year in which it is made provided the FMD does not exceed their net primary production income for that year (and including the amount in their assessable income in the income year in which it is repaid).

1.7 To be eligible for an FMD deduction, a taxpayer must (among other things) be an individual who carries on a business of primary production in Australia when the FMD is made. An individual is taken to carry on a primary production business carried on by a trustee of a trust during an income year if the individual is a beneficiary of the trust and is presently entitled to a share of the income of the trust for that year.

Australian Taxation Office's administration of the law

1.8 Before the High Court's decision in *Commissioner of Taxation v Bamford* (2010) 240 CLR 481 (Bamford), the Australian Taxation Office (ATO) regarded a beneficiary as presently entitled to a share of the trust income provided there was some gross trust income and the trustee exercised their discretion in favour of the beneficiary (or in the absence of an appointment or accumulation of income, the trust income had fallen to the beneficiary as a default beneficiary). Further, where there was no gross trust income, the ATO regarded a beneficiary (including a default beneficiary) as presently entitled to a share of trust income where they had a vested and indefeasible interest in trust income and were therefore deemed to be presently entitled to trust income (under subsection 95A(2) of the *Income Tax Assessment Act 1936* (ITAA 1936)).

1.9 These views, which were set out in Taxation Ruling TR 95/29, meant that a beneficiary (including default beneficiaries of a discretionary trust) could be taken to carry on a primary production business that was actually carried on by the trustee in a year where the trust had a loss for trust law purposes.

1.10 The effect of this was that such a beneficiary continued to be eligible for income averaging and was not required to have their FMDs repaid to them and included in their assessable income.

1.11 However, Bamford held that a beneficiary cannot be presently entitled to a share of income of a trust if there is no income legally available for distribution. Because of this, the ATO view in Taxation

Ruling TR 95/29 was no longer correct at law and the ruling was withdrawn on 30 June 2010 (although the ruling still applies to the 2009-10 and earlier income years).

Summary of new law

1.12 This Schedule amends the income averaging and FMD provisions to broadly reinstate the position that existed before the High Court's decision in Bamford and the ATO's consequent withdrawal of Taxation Ruling TR 95/29. That is, trust beneficiaries can continue to be eligible for income averaging and able to retain their FMDs in an income year where the trust does not have any trust income to which a beneficiary can be presently entitled (for example, because the trust has a loss for trust law purposes).

1.13 Beneficiaries of non-discretionary trusts are eligible for income averaging and able to retain their FMDs where a trust has no trust income for an income year to which a beneficiary could be presently entitled, if they would have been presently entitled to trust income if the trust had some trust income for that year that was legally available for distribution.

1.14 Beneficiaries of discretionary trusts are eligible for income averaging and able to retain their FMDs where there is no trust income for an income year to which a beneficiary could be presently entitled, if they are chosen by the trustee. The trustee may choose not more than the greater of:

- twelve beneficiaries; and
- the number of individual beneficiaries that for the previous income year were taken to carry on a primary production business carried on by the trustee for the purposes of the relevant provisions.

Comparison of key features of new law and current law

New law	***Current law***
Individual beneficiaries of non-discretionary trusts are eligible for income averaging and able to retain their FMDs where there is no trust income for an income year to which a beneficiary could be presently entitled, if they would have been presently entitled to trust income if the trust had some trust income for that year that was legally available for distribution.	Individual beneficiaries of non-discretionary trusts are not eligible for income averaging and are required to have their FMDs repaid to them where the trust does not have any trust income for an income year to which a beneficiary can be presently entitled (for example, because the trust has a loss for trust law purposes). (This is the position from 1 July 2010, if the law is not amended.)
Individual beneficiaries of discretionary trusts are eligible for income averaging and able to retain their FMDs where there is no trust income for an income year to which a beneficiary could be presently entitled, if they are chosen by the trustee. The trustee may choose not more than the greater of: • twelve beneficiaries; and • the number of individual beneficiaries that for the previous income year were taken to carry on a primary production business carried on by the trustee for the purposes of the relevant provisions.	Individual beneficiaries of discretionary trusts are not eligible for income averaging and are required to have their FMDs repaid to them where the trust does not have any trust income for an income year to which a beneficiary can be presently entitled (for example, because the trust has a loss for trust law purposes). (This is the position from 1 July 2010, if the law is not amended.)

Detailed explanation of new law

1.15 A beneficiary of a trust, the trustee of which carries on a primary production business, will be taken to carry on that business and therefore be eligible for income averaging and to retain their FMDs, in the circumstances outlined below.

Primary producers' income averaging

A trust with trust income to which a beneficiary can be presently entitled

1.16 There is no change to the existing treatment of a beneficiary of a trust where the trustee carries on a primary production business and there is an amount of trust income to which a beneficiary can be presently entitled. A beneficiary of a trust that carries on a primary production business in Australia is generally taken to carry on a primary production business carried on by the trustee of the trust where they are presently entitled to a share of the trust income for the income year. A beneficiary is not, however, taken to carry on the primary production business carried on by a trustee if they are presently entitled to less than $1,040 of the trust income, unless the Commissioner of Taxation (Commissioner) is satisfied that their interest was not acquired or granted wholly or primarily to enable access to the income averaging provisions. ***[Schedule 1, item 1, subsection 392-20(1) and item 2, subsection 392-20(2)]***

A primary production business which is carried on by a trust with no trust income

1.17 Where a trustee of a trust carries on a primary production business in Australia, but the trust has no trust income for the income year to which a beneficiary can be presently entitled, the beneficiary is taken to carry on that primary production business if specified conditions are met. The necessary conditions depend on whether the trust:

- has *certain entitlements* — commonly called a fixed trust; or
- does not have *certain entitlements* — commonly called a discretionary trust.

Trusts with certain entitlements

1.18 A beneficiary is taken to carry on a primary production business carried on by the trustee of a trust if the trust does not have any trust income to which a beneficiary could be presently entitled, and:

- at all times during the income year, the manner or extent to which each beneficiary of the trust can benefit from the trust is not capable of being significantly affected by the exercise, or non-exercise, of a power (*certain entitlements*); and

- if the trust had trust income for the income year the beneficiary would have been presently entitled to a share of this income.

[Schedule 1, item 1, subsection 392-20(1) and item 2, subsection 392-20(3)]

1.19 The *certain entitlements* requirement is broadly similar to the *no material discretionary elements* approach in Subdivision 126-G (CGT roll-over relief for the transfer of assets between fixed trusts) of the ITAA 1997, which was enacted by the *Tax Laws Amendment (2009 Measures No. 6) Act 2010*.

1.20 The *certain entitlements* requirement must be satisfied by each of the beneficiaries of the trust. Each beneficiary of the trust must have an interest in the trust that is of a sufficiently definable quality and extent as to be capable of measurement without the exercise or non-exercise of a power (in the sense discussed in *Gartside v Inland Revenue Commissioners* [1968] 2 WLR 277). The quality or extent of each beneficiary's interest should not be capable of being defeated or substantively altered by the exercise, or non-exercise, of a power. The requirement has regard to the exercise, or non-exercise, of a power by any entity, and not just the trustee of the trust.

1.21 For these purposes, a power includes both trust powers (that is, powers that must be exercised but which allow discretion as to when or how they are exercised) and mere powers (that is, discretions), but does not include trustees' duties. A trustee duty is a thing a trustee must do as prescribed, or refrain from doing, to avoid being in breach of trust (refer to the discussion in *Jacobs' Law of Trusts in Australia*, 7th ed., Heydon and Leeming at [1606]).

Example 1.1: Trusts in which beneficiaries have *certain entitlements*

The trustee of the Wilson Trust carries on a primary production business during the 2010-11 income year. At all times during this income year, the manner or extent to which each beneficiary of the trust can benefit from the trust is not capable of being significantly affected by the exercise, or non-exercise, of a power.

Kevin is a beneficiary of the Wilson Trust. Kevin's interest in the trust entitles him to receive 20 per cent of the trust's income for the income year.

In the 2010-11 income year the Wilson Trust has a loss for trust law purposes. As the trust meets the *certain entitlements* requirement and as Kevin would have been presently entitled to a share of the trust income had the trust had some trust income for the income year, Kevin is taken to carry on the primary production business carried on by the

trustee of the Wilson Trust for the purposes of income averaging and FMDs.

1.22 Examples of powers that may be capable of significantly affecting the manner and extent to which a beneficiary can benefit from a trust were set out in the explanatory memorandum to the Tax Laws Amendment (2009 Measures No. 6) Bill 2009 in paragraph 1.34. That explanatory memorandum also set out examples of powers that would not be regarded as significantly affecting the manner and extent to which a beneficiary can benefit from a trust in paragraphs 1.35 and 1.36.

Trusts without certain entitlements

1.23 Trustees of trusts that do not meet the *certain entitlements* requirement may, for an income year for which the trust has no trust income, choose a certain number of beneficiaries to be taken as carrying on the primary production business carried on by the trustee of the trust for that income year. The trustee may choose not more than the greater of:

- twelve beneficiaries; and
- the number of individual beneficiaries that for the previous income year were taken to carry on a primary production business carried on by the trustee for the purposes of the income averaging provisions.

[Schedule 1, item 1, subsection 392-20(1), item 2, subsection 392-20(4) and item 3, subsections 392-22(1) and (2)]

1.24 A choice is made for an income year and needs to be in writing and signed by the trustee and the beneficiary chosen. The choice must be made before the lodgment of the trust's income tax return for the income year for which the choice is to apply, unless the Commissioner allows extra time for a choice to be made. A choice cannot be varied and is irrevocable. ***[Schedule 1, item 3, subsections 392-22(1) and (3) to (5)]***

Example 1.2: Trusts in which beneficiaries do not have *certain entitlements*

Aaron, Elizabeth, Michael and Daniel are beneficiaries of the Bennett Trust. The Bennett Trust does not meet the *certain entitlements* requirement. The trustee of the Bennett Trust carries on a business of primary production during the 2010-11 income year, however, the trust has a loss for trust law purposes for this income year.

The trustee chooses Aaron, Elizabeth, Michael and Daniel for the purposes of the income averaging provisions for the 2010-11 income

year. They are therefore treated as carrying on the primary production business carried on by the trustee of the Bennett Trust for the purposes of these provisions and their primary production income for the income year is nil (they do not have any primary production income from any other source).

Aaron and Elizabeth also hold FMDs during the 2010-11 income year. The trustee also chooses them for the purposes of the FMD provisions for the income year. They are therefore taken to carry on the primary production business carried on by the trustee of the Bennett Trust for the purposes of these provisions and are able to retain their FMDs for the income year.

Michael and Daniel have not been chosen by the trustee for the purposes of the FMD provisions and are therefore not taken to carry on the primary production business carried on by the trustee of the Bennett Trust for the purposes of these provisions.

Example 1.3: Choice of beneficiaries by trustees of trusts in which beneficiaries do not have *certain entitlements*

The trustee of the Swain Trust carried on a business of primary production during the 2009-10 income year. During that income year Bruce, Judith, their six children, and their children's six spouses, were all presently entitled to a share of trust income and were therefore taken to carry on the primary production business carried on by the trustee for the purposes of income averaging and FMDs.

The trustee of the Swain Trust carries on a business of primary production during the 2010-11 income year, however, the trust has a loss for trust law purposes for this income year. The Swain Trust does not meet the *certain entitlements* requirement. As there were 14 beneficiaries that were taken to carry on the primary production business carried on by the trustee for the purposes of income averaging and FMDs in the 2009-10 income year, the trustee is able to nominate not more than 14 beneficiaries for the purposes of income averaging and FMDs for the 2010-11 income year. The trustee need not nominate the same beneficiaries, or even the same number of beneficiaries, for both the income averaging and FMD provisions.

Farm management deposits

A trust with trust income to which a beneficiary can be presently entitled

1.25 There is no change to the existing treatment of a beneficiary of a trust where the trustee carries on a primary production business and there is an amount of trust income to which a beneficiary can be presently entitled. An individual beneficiary of a trust that carries on a primary production business in Australia is generally taken to carry on a primary

production business carried on by the trustee of the trust where they are presently entitled to a share of the trust income for the income year. ***[Schedule 1, items 9 and 10, subsections 393-25(3) and (4)]***

A primary production business which is carried on by a trust with no trust income

1.26 Where a trustee carries on a primary production business in Australia, but the trust has no trust income for the income year, an individual beneficiary of the trust will be taken to carry on a primary production business carried on by the trustee for an income year for the purposes of the FMD provisions in substantively the same way as for the income averaging provisions (see paragraphs 1.17 to 1.24). ***[Schedule 1, item 9, subsection 393-25(3), item 10, subsections 393-25(5) and (6), item 11, section 393-27]***

Application and transitional provisions

1.27 These amendments, which are favourable to taxpayers, apply where the income year of the trust is the 2010-11 income year or a later income year. ***[Schedule 1, item 14]***

Special transitional rule

1.28 The current FMD provisions, including subsection 393-25(3), only apply from the 2010-11 income year. For income years before this the FMD provisions were contained in Schedule 2G to the ITAA 1936. To ensure that the amendments allowing a trustee of a trust without *certain entitlements* to nominate beneficiaries for the purposes of the FMD provisions operate appropriately in the 2010-11 income year, a transitional provision is inserted into the *Income Tax (Transitional Provisions) Act 1997*. For the purpose of determining the maximum number of choices that the trustee may make under subsection 393-27(2) for the 2010-11 income year, subsection 393-25(3) is treated as having applied to a beneficiary covered by paragraph (c) of the definition of 'primary producer' in section 393-25 in Schedule 2G to the ITAA 1936 in the 2009-10 income year. ***[Schedule 1, item 13, section 393-27 of the Income Tax (Transitional Provisions) Act 1997]***

Consequential amendments

1.29 A consequential amendment is made to repeal subsection 392-20(3) and re-enact it as subsection 392-20(5). This subsection operates to deny income averaging for beneficiaries of

corporate unit trusts (Division 6B of the ITAA 1936) and public trading trusts (Division 6C of the ITAA 1936) in respect of their interest in the trust. ***[Schedule 1, item 2, subsection 392-20(5)]***

1.30 Consequential amendments are made to insert suitable subheadings before subsections 393-25(2) and (3). A consequential amendment is also made to the FMD provisions to re-enact subsection 393-25(4), which is about the application of Division 393 of the ITAA 1997 and Division 4A of Part VA of the ITAA 1936 to a beneficiary who is no longer under a legal disability, as section 393-28. ***[Schedule 1, items 7 and 8, subsections 393-25(2) and (3) and item 11, section 393-28)]***

1.31 A consequential amendment is made to the note to item 1 in the table in section 393-35 to update the references to section 393-25. ***[Schedule 1, item 12, section 393-35 (note to item 1 in the table)]***

1.32 A consequential amendment is made to note 2 to subsection 393-5(1) to update the references to section 393-25. ***[Schedule 1, item 6, subsection 393-5(1) (note 2)]***

1.33 A consequential amendment is made to the note to section 97A of the ITAA 1936 to update the references to section 393-25. ***[Schedule 1, item 4, note to section 97A of the ITAA 1936]***

1.34 A consequential amendment is made to the note to section 202DL of the ITAA 1936 to update the references to the FMD provisions. ***[Schedule 1, item 5, note to section 202DL of the ITAA 1936]***

Chapter 2
Interim changes to improve the taxation of trust income

Outline of chapter

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

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

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

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

Context of amendments

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

2.6 The Court clarified that:

- 'income of the trust estate' in section 97 of the ITAA 1936 refers to the distributable income of the trust as determined according to trust law and in accordance with the deed; and

- 'share' means 'proportion' such that once the share of the distributable income of the trust to which the beneficiary is presently entitled is determined, the beneficiary is assessed on that same percentage share of the trust's net income as defined in section 95 of the ITAA 1936 (hereafter referred to as the trust's 'taxable income').
  - This interpretation of the term 'share' is referred to as the proportionate approach.

2.7 This decision has highlighted a number of longstanding problems with the taxation of trusts. In particular, it has highlighted that the amounts on which a beneficiary is assessed do not always match the amounts that they are entitled to under trust law. This mismatch can result in unfair outcomes, as well as opportunities for tax manipulation.

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

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

Government response

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

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

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

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

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

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

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

2.16 Further, as a result of consultation on exposure draft legislation, the Government has provided a carve-out for managed investment trusts (MITs) and certain trusts treated like MITs in recognition that these trusts generally do not 'stream' capital gains or franked distributions and instead distribute all of their trust income proportionally. This carve-out enables MITs to use the current 'proportional approach' in Division 6 until the Government's new MIT regime commences on 1 July 2012. The trustees of these trusts can still choose to apply these amendments provided they make a valid election for the 2010-11 or 2011-12 income year.

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

2.18 The Government is aware that these amendments do not address all of the current problems and uncertainties related to the taxation of

trusts. However, these amendments address key anomalous outcomes and provide certainty in relation to the streaming of capital gains and franked distributions (including any attached franking credits).

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

Summary of new law

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

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

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

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

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

Comparison of key features of new law and current law

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

New law	***Current law***
An exempt entity is taken *not* to be presently entitled to any amount of the trust's income unless they have either been paid or notified of their entitlement, within two months of the end of the income year. The amount that would otherwise be that beneficiary's share of taxable income is assessed to the trustee.	No equivalent.
Where an exempt entity is used to 'shelter' a share of the taxable income of a trust that exceeds the exempt entity's entitlement to the net accretions to the trust underlying that taxable income (whether 'income' or 'capital' of the trust), that excess is assessed to the trustee.	An exempt entity can be made presently entitled to all of the income of a trust estate (as calculated under trust law) resulting in the trust's total taxable income becoming exempt — even where the entity is not entitled to receive all of the net taxable accretions to the trust underlying that taxable income (whether 'income' or 'capital' of the trust).

Detailed explanation of new law

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

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

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

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

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

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

2.30 This part of the explanatory memorandum explains:

- the order in which to apply the new provisions (see paragraphs 2.31 to 2.34);
- when streaming of capital gains and franked distributions will be effective for tax purposes and what is required for a beneficiary to be 'specifically entitled' to these amounts (see paragraphs 2.35 to 2.70);
- calculating the 'adjusted Division 6 percentage' for the purposes of Subdivisions 115-C and 207-B (see paragraphs 2.71 to 2.75);
- the treatment of capital gains under Subdivision 115-C (see paragraphs 2.76 to 2.113);
- the treatment of franked distributions and franking credits under Subdivision 207-B (see paragraphs 2.114 to 2.149);
- the application of new Division 6E of the ITAA 1936 (hereafter referred to as Division 6E) to adjust the assessable amounts under Division 6 (see paragraphs 2.150 to 2.164);
- the combined effect of the streaming amendments (see paragraphs 2.165 to 2.169); and
- the specific anti-avoidance rules for exempt entities that are used to 'shelter' taxable income of a trust disproportionately to their entitlements (see paragraphs 2.170 to 2.202).

The order in which to apply the provisions

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

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

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

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

When 'streaming' is effective for tax purpose — 'specifically entitled'

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

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

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

- the beneficiary must receive, or reasonably be expected to receive, an amount equal to the 'net financial benefit' referable to the capital gain or franked distribution in the trust; and

- the entitlement must be recorded in its character as such in the accounts or records of the trust (see paragraph 2.62).

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

2.38 Broadly, a beneficiary will be specifically entitled to the fraction of the (gross) *tax* amount that equals their fraction of the net *trust* amount referable to the capital gain or franked distribution. For example, a beneficiary that receives an amount specified to be half of the trust's profit from the sale of an asset will generally be specifically entitled to half of the (tax) capital gain realised on the asset. ***[Schedule 2, item 11, subsection 115-228(1) and item 24, subsection 207-58(1)]***

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

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

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

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

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

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

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

- $50 referable to a franked distribution;

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

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

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

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

Example 2.1

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

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

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

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

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

'Net financial benefit'

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

Financial benefit

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

Reduced by losses or expenses

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

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

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

Example 2.2

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

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

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

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

Exception for capital gains and the market value substitution rule

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

Referable to a capital gain or franked distribution

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

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

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

Example 2.3

The Zhang Trust buys an investment property in 2001 for $100,000. The trustee of the trust has the power to revalue the property according

to generally accepted accounting principles and treat any increase in its value as income of the trust.

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

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

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

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

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

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

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

2.56 It is not possible to stream tax amounts to beneficiaries where there is no referable net financial benefit remaining in the trust — such as when the gross benefit has been reduced to zero by losses or directly relevant expenses. ***[Schedule 2, item 11, subsection 115-228(1) and item 24, subsection 207-58(1)]***

Example 2.4

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

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

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

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

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

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

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

Example 2.5

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

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

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

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

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

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

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

A beneficiary cannot be specifically entitled to franking credits

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

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

Recorded in its character as a capital gain/franked distribution

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

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

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

- Under the trust deed, a beneficiary is entitled to all of the capital gains of the trust.
- The trustee resolves to distribute all of the dividends of the trust to a beneficiary.

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

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

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

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

When the record must be made by

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

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

Creating specific entitlement through a chain of trusts

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

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

Example 2.6

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

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

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

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

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

Calculating the 'adjusted Division 6 percentage'

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

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

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

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

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

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

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

Example 2.7

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

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

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

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

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

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

Treatment of capital gains under amended Subdivision 115-C

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

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

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

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

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

Changes to the general application of Subdivision 115-C

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

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

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

Calculating the amount of extra capital gain for a beneficiary

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

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

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

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

Step 1 — determine the beneficiary's share of the capital gain of the trust

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

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

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

2.86 As described in paragraphs 2.35 to 2.70, a beneficiary that receives all of the net financial benefit referable to a capital gain (after the application of relevant losses) may be specifically entitled to the entire

(tax) capital gain. For the purposes of determining specific entitlement only, the losses (a trust concept) must be applied in a way that is consistent with how the trustee applies capital losses for tax purposes.

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

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

Example 2.8

> The Little Trust generated $100 of rent and a $600 capital gain (which was a discount capital gain). The trust also had a capital loss of $100.
>
> The trust deed does not define 'income' and therefore capital gains do not form part of the trust income. As a result, the income of the trust estate is $100 and the taxable income is
> $350 ($100 + ($600 − $100)/2)
>
> The trustee resolves to distribute $300 related to the capital gain (after absorbing the capital loss) to Catherine and the $100 of rent to Aaron.
>
> Catherine is specifically entitled to 60 per cent of the $600 capital gain under subsection 115-228(1) because she can reasonably be expected to receive the economic benefit of 60 per cent ($300) of the $500 capital gain remaining after accounting for the $100 capital loss. Under section 115-227, Catherine's share of the capital gain is $360 (60 per cent of the $600 capital gain).
>
> Aaron's share of the capital gain is $240 under section 115-227 because he has an adjusted Division 6 percentage of 100 per cent (since none of the capital gain is treated as trust income) and there is $240 of the $600 capital gain to which no one is specifically entitled.

Step 2 — divide by the total capital gain

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

Example 2.9

> Continuing from Example 2.8, Catherine divides her share of the capital gain ($360) by the total capital gain ($600) and therefore has 6/10 of the capital gain under paragraph 115-225(1)(b).
>
> Aaron divides his share of the capital gain ($240) by the total capital gain ($600) and therefore has 4/10 of the capital gain under paragraph 115-225(1)(b).

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

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

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

- This would equal the trust's net capital gain assuming the trust only had the one capital gain.
- Consistent with the CGT regime, the trustee can choose the order in which they apply the losses. This may reduce the taxable amount for a particular capital gain to zero.

Example 2.10

> Continuing from Example 2.9, the taxable income relating to the capital gain calculated under paragraph 115-225(1)(a) is $250.
>
> Catherine's attributable gain calculated under subsection 115-225(1) is $150 ($250 − 6/10).
>
> Aaron's attributable gain calculated under subsection 115-225(1) is $100 ($250 × 4/10).

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

2.93 The rateable reduction applies where the trust's net capital gain and (total) franked distributions (net of directly relevant deductions) are together greater than the taxable income of the trust (excluding franking credits). ***[Schedule 2, item 11, subsection 115-225(2)]***

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

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

$$\frac{\text{Taxable income of the trust (excluding franking credits)}}{\text{net capital gain of the trust + 'net franked distributions'}}$$

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

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

Example 2.11

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

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

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

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

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

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

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

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

- If both discounts applied, the amount is quadrupled.

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

Example 2.12

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

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

Assessing the trustee in respect of a beneficiary under section 98

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

- This applies even if the only reason that the section 98 assessment arises is because the beneficiary has a share of a capital gain ***[Schedule 2, item 11, subsection 115-220(1)]***.

- That is, section 115-220 will apply where a non-resident beneficiary or a beneficiary under a legal disability is specifically entitled to all or part of a capital gain, regardless of whether they have any entitlement to income of the trust.

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

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

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

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

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

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

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

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

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

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

Option for resident trustee to be assessed on a capital gain

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

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

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

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

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

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

Example 2.13

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

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

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

The capital unit-holders are specifically entitled to the capital gain (the financial benefits referable to that gain being reflected in the value of their units, with the trust deed setting out their entitlement to the capital gains of the trust, in their character as capital gains), but currently have no right to demand payment of it. Without more, they would be treated as having extra capital gains in respect of this gain under subsection 115-215(3), but would have no corresponding cash flow from which to pay the associated tax liability.

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

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

Interaction with Division 855 — capital gains and foreign residents

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

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

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

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

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

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

Changes to the general application of Subdivision 207-B

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

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

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

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

Share of franking credit

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

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

Calculating the attributable franked distribution of a beneficiary or trustee

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Example 2.14

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

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

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

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

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

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

Example 2.15

> Continuing on from Example 2.14 Sharon's fraction of the franked distribution is calculated by dividing her share of the franked distribution ($28) by the total franked distribution ($70).
>
> Her fraction of the franked distribution is therefore $28/$70 or 2/5ths.
>
> The same calculation applies for Audrey. Her fraction of the franked distribution is calculated by dividing her share of the franked distribution ($42) by the total franked distribution ($70).
>
> Her fraction of the franked distribution is therefore $42/$70 or 3/5ths

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

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

Example 2.16

> Continuing from Example 2.15 the amount of the franked distribution remaining after reducing it by the $50 interest deduction is $20 ($70 − $50).
>
> Sharon's attributable franked distribution is therefore $8, calculated by multiplying 2/5ths by $20.
>
> Audrey's attributable franked distribution is $12, calculated by multiplying 3/5ths by $20.

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

Specifically entitled to an amount of a franked distribution

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

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

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

2.136 A beneficiary of a trust that receives a franked distribution cannot generally be made specifically entitled to any share of that distribution if the whole of the distribution is sheltered at the trust level by directly relevant expenses. Moreover, despite being able to be reduced by directly relevant expenses, a beneficiary's share of the net financial benefit referrable to a franked distribution can never be less than nil.

Example 2.17

> The Charlie Trust derives a distribution of $100 and incurs directly related expenses of $150. Under the deed of the trust, Mark is entitled to all of the dividend income of the trust.
>
> Mark is not specifically entitled to any portion of the distribution as the distribution is entirely sheltered by directly related expenses at the trust level.
>
> If instead the directly related expenses totalled only $90, the effect of the deed is to make Mark presently entitled to the $10 of trust income relating to the distribution. However for the purposes of section 207-58, Mark is specifically entitled to the whole of the distribution as his share of the net financial benefit associated with the distribution equals that total net financial benefit.

Trustee distributes all of the franked distributions within a single class

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

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

2.139 A *class of income* means an appropriate subset of trust income (and not all trust income generally) of which franked distributions are a generally accepted inclusion, such as 'franked dividends', 'dividends' or 'passive income'. Expenses that are directly relevant to all of the class of income may be charged against that class for trust purposes. However, for the purposes of determining specific entitlement, only the expenses directly relevant to the franked distributions will be taken into account (see paragraph 2.53). ***[Schedule 2, item 24, section 207-59]***

Example 2.18

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

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

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

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

was one of the two distributions to which he was purportedly entitled). This is because the franked distributions of the trust would not have been distributed within a single class.

Allocation of additional amounts of assessable income

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

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

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

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

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

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

Beneficiaries of a trust and partners in a partnership

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

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

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

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

Example 2.19

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

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

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

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

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

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

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

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

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

Trustees

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

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

Example 2.20

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

When Division 6E applies

2.155 Division 6E applies where:

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

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

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

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

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

Division 6E income of the trust estate

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

Example 2.21

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

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

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

Example 2.22

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

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

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

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

Division 6E net income of the trust estate

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

Example 2.23

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

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

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

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

- for each capital gain taken into account in working out the taxable income of the trust:
  - the beneficiary's share of the capital gain as determined under Subdivision 115-C, to the extent that it was included in the income of the trust estate; and
- for each franked distribution taken into account in working out the taxable income of the trust:
  - the beneficiary's share of the franked distribution as determined under Subdivision 207-B to the extent that it was included in the income of the trust estate.

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

Example 2.24

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

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

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

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

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

Division 6E may increase a taxpayer's Division 6 assessable amount

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

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

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

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

- when a beneficiary is specifically entitled to an amount of a capital gain or (net) franked distribution, they are only taxed

by reference to that amount (unless they are also presently entitled to other trust income); and

- all of the taxable income of the trust is brought to tax.

Example 2.25

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

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

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

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

- The Division 6E income of the trust is $100 under subsection 102UY(2).

- The Division 6E net income of the trust is $900 under subsection 102UY(3).

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

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

Beneficiary	***Original section 97 amount***	***Adjusted section 97 amount (section 94ZC)***
Aaron	$500	$0
Bennett	$500	$900

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

Combined operation of the streaming provisions

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

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

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

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

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

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

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

Example 2.26

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

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

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

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

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

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

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

Example 2.27

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

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

- To Ash $50,000 of 'income' and a $100,000 capital distribution that is specified to be attributable to the discount capital gain.
- To Bradshaw: a $50,000 capital distribution specified to be attributable to the non-discount capital gain (the other $50,000 is retained to replenish the trust corpus for the prior year capital loss).
- To Claire: $20,000 of income specified to be wholly attributable to the first (net) franked distribution.
- To Dawson: the balance of distributable income. (She is therefore entitled to $120,000 ($190,000 − $50,000 − $20,000.)

Step 1 — Apply Division 6 unmodified by Division 6E

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

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

Step 2 — calculate beneficiaries' adjusted Division 6 percentage

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

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

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

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

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

Step 3 — apply Subdivision 115-C

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

Concept/provision	***Ash***	***Bradshaw***	***Claire***	***Dawson***
Specific entitlement 115-227(a)	$100,000	$100,000	N/A	$0
Adjusted Division 6 percentage share 115-227(b)	$29,400	$0	N/A	$70,600
Share of capital gain (amount) 115-227	$129,400	$100,000	N/A	$70,600
(Total) capital gain	$200,000	$100,000	N/A	$200,000
Fraction of the gain 115-225(1)(b)	64.7%	100%	N/A	35.3%

Concept/provision	***Ash***	***Bradshaw***	***Claire***	***Dawson***
Tax related to gain 115-225(1)(a)	$100,000	$50,000	N/A	$100,000
Attributable gain 115-225(1)	$64,700	$50,000	N/A	$35.300
Gross up? 115-215(3)	Yes	No	N/A	Yes
Extra capital gain 115-215(3)	$129,400	$50,000	N/A	$70,600

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

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

Step 4 — apply Subdivision 207-B

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

Concept/provision	***Ash***	***Bradshaw***	***Claire***	***Dawson***
Specific entitlement 207-55(4)(a)	$0	N/A	$70,000	$0
Adjusted Division 6 percentage share 207-55(4)(b)	$20,580	N/A	$0	$49,420
Share of franked distribution (amount) 207-55 (via table)	$20,580	N/A	$70,000	$49,420

Concept/provision	*Ash*	*Bradshaw*	*Claire*	*Dawson*
Fraction of the distribution 207-37(1)(b)	29.4%	N/A	100%	70.6%
Tax related to distribution 207-37(1)(a)	$70,000	N/A	$20,000	$70,000
Franking credit 207-35(4)(b)(i)	$8,820	N/A	$30,000	$21,180
Attributable franked distribution 207-35(4)(b)(ii)	$20,580	N/A	$20,000	$49,420

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

Step 5 — recalculate assessable amounts using Division 6E

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

- The Division 6E income of the trust estate is $100,000, because the $90,000 attributable to the franked distributions is disregarded.

- The Division 6E net income is also $100,000 (from the general facts set out in Example 2.26).

- Ash's Division 6E present entitlement is $29,420 (calculated under subsection 102UY(4) of the ITAA 1936 as his present entitlement to trust income of $50,000 minus his share of franked distributions of $20,580 — note that his share of the capital gain of the trust is not part of trust income).

- Bradshaw and Claire have no Division 6E present entitlement as their only entitlements were to capital gains and franked distributions respectively.

- Dawson's Division 6E present entitlement is $70,580 (calculated under subsection 102UY(4) of the ITAA 1936 as her present entitlement to trust income of $120,000 minus her share of franked distributions of $49,420).

The modified amounts assessable under Division 6 are as follows:

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

Step 6 — overall result

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

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

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

Example 2.28

Following on from Example 2.27, suppose that the trust had carry forward tax losses of $280,000. The taxable income of the trust is therefore $120,000 ($400,000 − $280,000). (The trust income does not change and assume that the trustee's resolutions also do not change.)

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

Therefore:

- Ash reduces his extra capital gain to $32,350 ($129,400/4) and his assessable franked distribution to $5,145 ($20,580/4).

- Bradshaw reduces his extra capital gain to $12,500 ($50,000/4).

- Claire reduces her attributable franked distribution to $5,000 ($20,000/4).

- Dawson reduces her extra capital gain to $17,650 ($70,600/4) and his attributable franked distribution to $12,355 ($49,420/4).

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

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

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

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

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

Example 2.29

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

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

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

Step 1 — apply Division 6 unmodified by Division 6E

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

Beneficiary	***Present entitlement***	***Division 6 percentage***	***Section 97 share of net income***
Ash	$150,000	44.1% $150,000/$340,000)	$176,471
Bradshaw	$50,000	14.7% ($50,000/$340,000)	$58,824
Claire	$20,000	5.9% ($20,000/$340,000)	$23,529
Dawson	$120,000	35.3% ($120,000/$340,000)	$141,176
Total	$340,000	100%	$400,000

Step 2 — calculate beneficiaries' adjusted Division 6 percentage

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

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

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

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

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

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

Step 3 — apply Subdivision 115-C

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

Concept/provision	*Ash*	*Bradshaw*	*Claire*	*Dawson*
Specific entitlement 115-227(a)	$100,000	$100,000	N/A	$0
Adjusted Division 6 percentage share 115-227(b)	$45,500	$0	N/A	$54,500
Share of capital gain (amount) 115-227	$145,500	$100,000	N/A	$54,500
(Total) capital gain	$200,000	$100,000	N/A	$200,000

Concept/provision	*Ash*	*Bradshaw*	*Claire*	*Dawson*
Fraction of the gain 115-225(1)(b)	72.8%	100%	N/A	27.3%
Tax related to gain 115-225(1)(a)	$100,000	$50,000	N/A	$100,000
Attributable gain 115-225(1)	$72,750	$50,000	N/A	$27,250
Gross up 115-215(3)	Yes	No	N/A	Yes
Extra capital gain 115-215(3)	$145,500	$50,000	N/A	$54,500

Step 4 — apply Subdivision 207-B

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

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

Step 5 — recalculate assessable amounts using Division 6E

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

- The Division 6E income of the trust estate is still $100,000, because the $150,000 attributable to the capital gains and the $90,000 attributable to the franked distributions are disregarded. The Division 6E net income is also still $100,000.

- Ash's Division 6E present entitlement is $45,400 — calculated under subsection 102UY(4) of the ITAA 1936 as his present entitlement to trust income of $150,000 minus his $31,850 share of franked distributions and minus $72,750 (since only half of his $145,500 share of the capital gain is included in trust income).

- Dawson's Division 6E present entitlement is $54,600 — calculated under subsection 102UY(4) of the ITAA 1936 as her present entitlement to trust income of $120,000 minus her $38,150 share of franked distributions and minus $27,250 (since only half of her share of the capital gain is included in trust income).

The modified amounts assessable under Division 6 are as follows.

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

Step 6 — overall result

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

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

Example 2.30

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

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

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

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

Step 1 — apply Division 6 unmodified by Division 6E

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

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

Step 2 — calculate adjusted Division 6 percentage

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

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

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

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

Step 3 — apply Subdivision 115-C

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

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

Concept/provision	*Ash*	*Bradshaw*	*Claire*	*Dawson*
Specific entitlement 115-227(a)	$100,000	N/A	N/A	$0
Adjusted Division 6 percentage share 115-227(b)	$15,600	N/A	N/A	$84,400
Share of capital gain (amount) 115-227	$115,600	N/A	N/A	$84,400
(Total) capital gain	$200,000	N/A	N/A	$200,000
Fraction of the gain 115-225(1)(b)	57.8%	N/A	N/A	42.2%
Tax related to gain 115-225(1)(a)	$100,000	N/A	N/A	$100,000
Attributable gain 115-225(1)	$57,800	N/A	N/A	$42,200
Gross up 115-215(3)	Yes	N/A	N/A	Yes
Extra capital gain 115-215(3)	$115,600	N/A	N/A	$84,400

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

Concept/provision	*Ash*	*Bradshaw*	*Claire*	*Dawson*
Specific entitlement 115-227(a)	$0	$50,000	N/A	$0
Adjusted Division 6 percentage share 115-227(b)	$7,800	$0	N/A	$42,200
Share of capital gain (amount) 115-227	$7,800	$50,000	N/A	$42,200
(Total) capital gain	$100,000	$100,000	N/A	$100,000
Fraction of the gain 115-225(1)(b)	7.8%	50%	N/A	42.2%
Tax related to gain 115-225(1)(a)	$50,000	$50,000	N/A	$50,000
Attributable gain 115-225(1)	$3,900	$25,000	N/A	$21,100
Gross up 115-215(3)	No	No	N/A	No
Extra capital gain 115-215(3)	$3,900	$25,000	N/A	$21,100

Step 4 — apply Subdivision 207-B

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

Concept/provision	***Ash***	***Bradshaw***	***Claire***	***Dawson***
Specific entitlement 207-55(4)(a)	$0	N/A	$70,000	$0
Adjusted Division 6 percentage share 207-55(4)(b)	$10,920	N/A	$0	$59,080
Share of franked distribution (amount) 207-55 (via table)	$10,920	N/A	$70,000	$59,080
Fraction of the distribution 207-37(1)(b)	15.6%	N/A	100%	84.4%
Tax related to distribution 207-37(1)(a)	$70,000	N/A	$20,000	$70,000
Franking credit 207-35(4)(b)(i)	$4,680	N/A	$30,000	$25,320
Attributable franked distribution 207-35(4)(b)(ii)	$10,920	N/A	$20,000	$59,080

Step 5 – recalculate assessable amounts using Division 6E

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

- The Division 6E income of the trust estate is still $100,000, because everything except the net rental income is disregarded. The Division 6E net income is also still $100,000.

- Ash's Division 6E present entitlement is $15,680 (calculated under subsection 102UY(4) of the ITAA 1936 as his present entitlement to trust income of $150,000 minus his $123,400 share of capital gains ($115,600 plus $7,800) and his $10,920 share of franked distributions).

- Dawson's Division 6E present entitlement is $84,320 (calculated under subsection 102UY(4) of the ITAA 1936 as her present entitlement to trust income of $270,000 minus her $126,600 share of capital gains ($84,400 plus $42,200) and her $59,080 share of franked distributions).

The modified amounts assessable under Division 6 are as follows.

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

Step 6 — overall result

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

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

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

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

2.171 These rules do not apply to a trust that is a MIT (or a trust that is treated in the same way as a MIT for the purposes of Division 275) — even where the trustee of the MIT chooses to apply the other amendments in this Schedule that relate to the streaming of capital gains and franked distributions. ***[Schedule 2, item 6, subsections 100AA(7) and 100AB(8) of the ITAA 1936]***

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

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

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

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

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

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

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

Exempt entity not notified of (or paid) their entitlement

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

2.178 Section 100AA of the ITAA 1936 applies where:

- an exempt entity is presently entitled to an amount of the income of a trust estate;

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

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

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

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

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

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

Example 2.31

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

The trustee of the Daley Trust makes the Philips Trust, a charitable entity, presently entitled to all of the rental income. Ignoring the anti-avoidance rule, the Philips Trust would be notionally assessed on

all of the trust's taxable income of $100,000, although all of that income would be exempt from tax.

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

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

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

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

Example 2.32

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

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

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

As the Smith Trust has taken immediate action to notify the Quay Trust of its entitlement, and it was not unreasonable for the Smith Trust to be unaware of the Quay Trust's taxation status, the Commissioner decides to exercise his discretion under

subsection 100AA(4) of the ITAA 1936 to disregard the failure of the trustee of the Smith Trust to comply with subsection 100AA(1) of the ITAA 1936.

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

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

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

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

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

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

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

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

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

Adjusted Division 6 percentage

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

Benchmark percentage

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

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

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

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

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

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

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

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

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

- the amount of a franking credit included in the calculation of the trust's taxable income under subsection 207-35(1);
- an amount taken to be a dividend paid to the trustee of the trust pursuant to subsection 109D(1) of the ITAA 1936 (loans treated as dividends under Division 7A of Part III of the ITAA 1936);
- so much of the net income of one trust (the first trust) that is included under section 97 of the ITAA 1936 in the calculation of the net income of another trust, but which does

not represent a distribution of, or an entitlement to income of the first trust;

- so much of a net capital gain that is attributable to a reduction of what would have otherwise been a relevant cost base or reduced cost base of a CGT asset as a result of the market value substitution rule in section 112-20; and
- so much of a net capital gain that is attributable to an increase as a result of the market value substitution rule in section 116-30 of what would otherwise have been a relevant amount of capital proceeds for a CGT event.

2.199 An amount included in the taxable income of a trust as a result of the application of Part IVA of the ITAA 1936 is expressly included in the trust's adjusted net income, notwithstanding that it does not represent a net accretion of value to the trust estate. Excluding such an amount from the trust's adjusted net income would effectively 'unwind' the work done by Part IVA.

Example 2.33

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

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

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

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

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

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

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

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

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

Example 2.34

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

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

Notification

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

Application of benchmark percentage

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

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

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

Commissioner's discretion

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

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

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

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

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

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

Application and transitional provisions

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

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

Early balancers

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

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

Example 2.35

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

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

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

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

Managed investment trusts

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

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

2.210 However, if the trustee makes an effective choice to apply these amendments for the 2010-11 income year, the amendments also apply for

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

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

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

Example 2.36

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

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

Consequential amendments

2.213 Consequential amendments are necessary to reflect the changes to Subdivisions 115-C and 207-B. These Subdivisions now effectively assess capital gains and franked distributions included in a trust's taxable income (rather than these amounts being assessed under Division 6).

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

2.215 The Government is aware that, because of complex interactions in the current law, the general consequential amendments may not operate as intended in all cases. However, the application of the general rules to

other provisions of the income tax laws is subject to a contrary intention in the law.

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

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

General consequential rules

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

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

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

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

Specific amendments

2.222 The specific consequential amendments fall into two broad categories:

- removing or updating guide material and provisions that are no longer consistent with the changed application of Division 6 and Subdivisions 115-C and 207-B; and

- amendments to provisions within Division 6 to ensure that they interact appropriately with the two general consequential rules.

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

Chapter 3
National Rental Affordability Scheme

Outline of chapter

3.1 Schedule 3 to this Bill amends the *Income Tax Assessment Act 1997* (ITAA 1997) to address technical issues which have arisen from the interaction between the tax law and the *National Rental Affordability Scheme Act 2008* (NRAS Act).

3.2 All references are to the ITAA 1997 unless otherwise stated.

3.3 These amendments also simplify the operation of the National Rental Affordability Scheme (NRAS) for participants and provide some additional flexibility to NRAS participants in how the incentive is shared between members of consortiums participating in the NRAS.

3.4 Specifically, these amendments:

- replace the references in the NRAS provisions of the tax law to a non-entity joint venture with the broader concept of an NRAS consortium;
- recognise that the Secretary of the Department that administers the NRAS (Housing Secretary) does not issue certificates under the NRAS Act to consortiums participating collectively, but rather to an approved participant (the entity that is complying with NRAS legislative requirements) of an NRAS consortium;
- introduce an optional election to allow approved participants of NRAS consortiums to relinquish entitlements to a tax offset to certain other parties of their consortium; and
- extend the tax exemption already applying to state and territory NRAS-related payments to include such payments which are received indirectly by a taxpayer (for example, from another member of their NRAS consortium).

Context of amendments

Background

3.5 The NRAS is a Government initiative to stimulate the supply of new affordable rental dwellings. The initiative commenced on 1 July 2008.

3.6 Qualifying participants in the NRAS are eligible to receive an annual NRAS incentive for up to 10 years for each approved dwelling which is rented according to the requirements of the scheme.

3.7 These requirements include being rented to low or moderate income households at 20 per cent below the market rate.

3.8 The NRAS incentive is $9,140 per dwelling in 2010-11, comprising $6,855 from the Australian Government and $2,285 from the States. These amounts are indexed annually in line with the rents component of the consumer price index.

3.9 The Australian Government component of the incentive is delivered through a refundable tax offset, with endorsed charitable institutions able to instead receive a cash payment.

3.10 Division 380 of the ITAA 1997 provides for the NRAS tax offset.

Technical issues to be addressed

3.11 Under the current legislation, taxpayers collectively participating in the NRAS (other than through a partnership or trust arrangement) must be operating through a non-entity joint venture. ‘Non-entity joint venture’ is defined by subsection 995-1(1) of the ITAA 1997. It requires the Commissioner of Taxation (Commissioner) to be satisfied of the presence of a contractual arrangement under which multiple parties undertake an economic activity that is subject to a ‘control’ test.

3.12 The requirements attached to meeting the definition of ‘non-entity joint venture’ are restrictive to participants in the NRAS and do not accommodate certain structures wanting to operate in the NRAS. This will be addressed by these amendments.

3.13 Joint ventures between property developers, property managers, and individual investors have so far proved a popular vehicle for participating in the NRAS, enabling the pooling of their separate resources to collectively meet the minimum dwellings requirement.

3.14 However, under such arrangements, joint ventures may be legally structured in a way that results in the approved participant (manager) deriving NRAS rent and the investor deriving ordinary rent (this arrangement was highlighted in the Australian Taxation Office Interpretive Decision (ATO ID) 2009/146). In these cases the manager, rather than the ultimate investor, would be the entity entitled to the tax offset as the manager is the entity deriving NRAS rent. This will be addressed by these amendments.

Summary of new law

3.15 Taxpayers are entitled to an NRAS tax offset, which is a refundable tax offset, in the following circumstances.

- An individual, corporate tax entity or a superannuation fund is entitled to a refundable tax offset provided that the Housing Secretary has issued the particular entity a certificate under the NRAS. The amount of the tax offset is the amount stated in the certificate.

- The partners of a partnership and the beneficiaries of a trust are entitled to a refundable tax offset provided that the Housing Secretary has issued their partnership or trust (or a partnership or trust through which their interest is ultimately obtained) a certificate under the NRAS. The amount of the tax offset is the amount stated in the certificate, shared between the partners of a partnership or the beneficiaries of a trust according to their proportion of the NRAS rent of the partnership or trust for the NRAS year.

- A trustee of a trust (rather than the trust's beneficiaries) is entitled to a refundable tax offset provided that the Housing Secretary has issued the trustee a certificate under the NRAS and the trust has no net income. Similarly, a trustee of a trust (rather than the trust's beneficiaries) is entitled to a refundable tax offset if the NRAS refundable tax offset flows to this trust from another entity (because the trust is a party to a non-entity joint venture, the trust is a partner of a partnership, or the trust is a beneficiary of another trust which has net income) and the trust to which the offset flows has no net income. Trustees assessable on net income of the trust are also entitled to a share of the offset.

3.16 In addition to the above circumstances, groups of taxpayers collectively participating in the NRAS (via an NRAS consortium) may each become entitled to an NRAS tax offset.

3.17 A party to an NRAS consortium is entitled to an NRAS tax offset provided that the Housing Secretary has issued the approved participant of the consortium a certificate under the NRAS and the entity has been deriving NRAS rent.

3.18 The amount of the tax offset is the amount represented by the certificate shared between the members of the NRAS consortium according to their proportion of the NRAS rent from the NRAS dwelling for the NRAS year.

3.19 State and territory NRAS-related payments are non-assessable non-exempt income, whether received by a taxpayer directly or indirectly (for example, from another member of their NRAS consortium).

Comparison of key features of new law and current law

New law	***Current law***
Groups of taxpayers collectively participating in the NRAS need not establish a non-entity joint venture to enable each taxpayer to become entitled to an NRAS tax offset. The replacement concept of an NRAS consortium is a broader one than non-entity joint venture. Contractual arrangements establishing an NRAS consortium need only to facilitate the leasing of approved rental dwellings under the NRAS. There is no requirement that the economic activity be subject to the joint control of the parties.	Groups of taxpayers collectively participating in the NRAS and wishing to each become entitled to an NRAS tax offset must establish a non-entity joint venture for this purpose. This requires, *inter alia*, the presence of a contractual arrangement under which multiple parties undertake an economic activity that is subject to the joint control of the parties.
The NRAS consortium pathway applies where the Housing Secretary has issued the approved participant, on behalf of the NRAS consortium, with a certificate under the NRAS Act in relation to the rental dwelling.	The non-entity joint venture pathway in the tax law depends on the Housing Secretary having issued the non-entity joint venture with a certificate under the NRAS Act in relation to the rental dwelling.

New law	***Current law***
Approved participants (managers) of NRAS consortiums, where they are deriving NRAS rent, may elect to relinquish an entitlement to an NRAS tax offset to other members of their NRAS consortium.	The entity directly deriving the NRAS rent is entitled to the NRAS tax offset.
Payments (and non-cash benefits) made by state and territory governments in relation to participation in the NRAS are non-assessable non-exempt income. This applies whether this payment is received by the taxpayer directly or indirectly, such as through an NRAS consortium of which they are a member.	Payments by a state or territory government, in relation to participation in the NRAS, received indirectly by a taxpayer are treated as income in the hands of the taxpayer.

Detailed explanation of new law

3.20 When the National Rental Affordability Scheme Bill 2008 was introduced, the Government stated in Parliament that they expected the scheme would facilitate new and creative partnerships between institutional investors, developers and community housing providers.

NRAS consortiums

3.21 The definition of an 'NRAS consortium' recognises the existence of the new arrangements established for groups of taxpayers to participate collectively in the NRAS.

3.22 An ***NRAS consortium*** is defined as a consortium, joint venture or non-entity joint venture established by one or more contractual arrangements that facilitate the leasing of NRAS dwellings. ***[Schedule 3, item 17, subsection 995-1(1)]***

3.23 An ***NRAS dwelling*** means an approved rental dwelling for the purposes of the regulations made under the NRAS Act. ***[Schedule 3, item 18, subsection 995-1(1)]***

3.24 As the definition of 'NRAS consortium' includes non-entity joint ventures, the ongoing operation of section 380-10 of the ITAA 1997 for parties to existing non-entity joint ventures is assured.

3.25 In practice, many contractual arrangements may exist between different parties involved in various stages in preparing dwellings to be

leased under the NRAS. The NRAS consortium definition recognises that multiple contractual arrangements may exist.

3.26 The contractual arrangements must facilitate the leasing of approved rental dwellings under the NRAS, however, the contractual arrangements may also deal with other things.

3.27 A corporate tax entity, superannuation fund, trust or partnership cannot be an NRAS consortium. However, they may be a *member* of an NRAS consortium. ***[Schedule 3, item 17, subsection 995-1(1)]***

Members of an NRAS consortium

3.28 A member of an NRAS consortium is an entity that is a party to a contractual arrangement, or to one of the contractual arrangements, that established the NRAS consortium. A member of an NRAS consortium may not necessarily have been a party to the contractual arrangement at the time the NRAS consortium was established. ***[Schedule 3, item 14, subsection 995-1(1)]***

3.29 In practice, individual entities will enter into an individual contractual arrangement with the approved participant in regard to the rental dwellings to be rented under the NRAS.

3.30 A partnership may also be a member of a consortium if all the partners of the partnership are parties to a contractual arrangement that established the consortium. ***[Schedule 3, item 14, subsection 995-1(1)]***

3.31 The member of an NRAS consortium who is the approved participant represents the consortium when interacting with the Department of Sustainability, Environment, Water, Population and Community (DSEWPaC). ***[Schedule3, item 15, subsection 995-1(1)]***

Example 3.1: NRAS consortium

Affordable Rental Housing Group is a consortium comprising a manager (Affordable Rental Solutions Company) and 200 individual dwelling owners.

Affordable Rental Solutions Company applies to the Housing Secretary to participate in the NRAS and effectively represents the parties to the consortium. It is the ‘approved participant’.

The Affordable Rental Housing Group is a consortium established by contractual arrangements that facilitates the leasing of approved rental dwellings under the NRAS. It is an NRAS consortium.

Example 3.2: NRAS consortium

ABC Group is a consortium comprising an approved participant (Holding Pty Ltd), a tenancy manager (Real Estate Pty Ltd) and the owner of a rental dwelling.

There is a contractual agreement between Holding Pty Ltd and the owner of the rental dwelling, another contractual agreement between the owner of the rental dwelling and the tenancy manager and another between the tenancy manager and Holding Pty Ltd. All contractual agreements are to facilitate the leasing of approved rental dwelling under the NRAS.

ABC Group is an NRAS consortium.

Holding Pty Ltd, being the approved participant, represents the members of the consortium via interactions with the DSWEPaC.

Members of the NRAS consortiums are entitled to tax offsets

3.32 Members of an NRAS consortium are entitled to a tax offset for an income year if:

- a certificate has been issued to the approved participant in relation to the NRAS dwelling;
- the income year begins in the NRAS year to which the certificate relates;
- the member is an individual, a corporate tax entity or a superannuation fund; and
- the member has derived NRAS rent from an NRAS dwelling covered by the certificate during the NRAS year.

[Schedule 3, item 1, subsections 380-10(1) and (2)]

3.33 Section 380-10 of the ITAA 1997 deals with claims by a member of an NRAS consortium that is an individual, corporate tax entity or a superannuation fund. It is the mechanism by which groups of taxpayers collectively participating in the NRAS each become entitled to an NRAS tax offset.

3.34 As mentioned above, NRAS consortiums may be legally structured in many ways. In some cases investors may be deriving NRAS rent directly, while in other cases, where there is the presence of a head lease (between the investor and the manager) and sublease (between the manager and the eligible tenant), the manager of the rental dwellings will

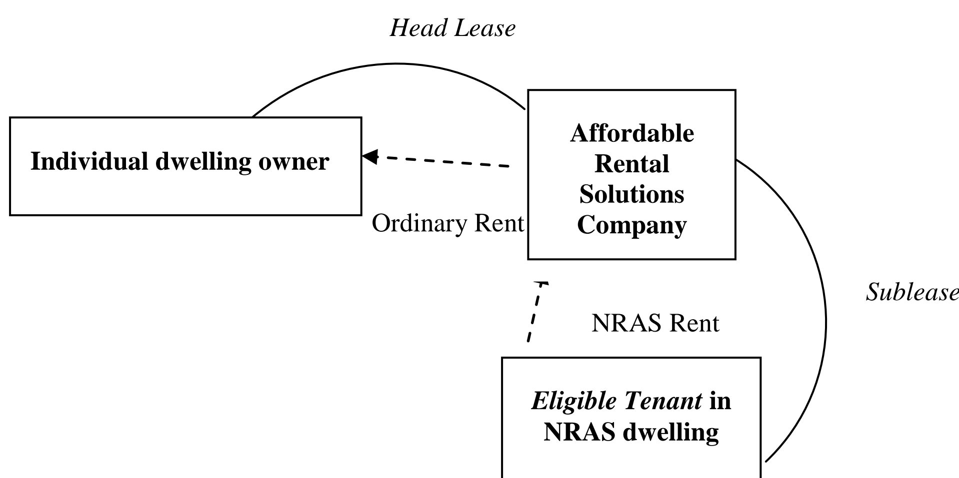
be the entity deriving NRAS rent and the investor will be deriving ordinary rent from the manager.

3.35 One element that needs to be satisfied for a member to be entitled to the NRAS tax offset under section 380-10 is that the member has derived NRAS rent. ***NRAS rent*** is defined as rent derived from a rental dwelling under the NRAS for an income year. ***[Schedule 3, item 19, subsection 995-1(1)]***

Example 3.3: NRAS rent derived by the approved participant

Affordable Rental Housing Group is an NRAS consortium comprising a manager (Affordable Rental Solutions Company) and 200 individual dwelling owners.

Under this NRAS consortium, the individual dwelling owners enter into head leases with the Affordable Rental Solutions Company and then the company enters into subleases with the eligible tenants. (This arrangement is the same as the arrangement outlined in ATO ID 2009/146.)



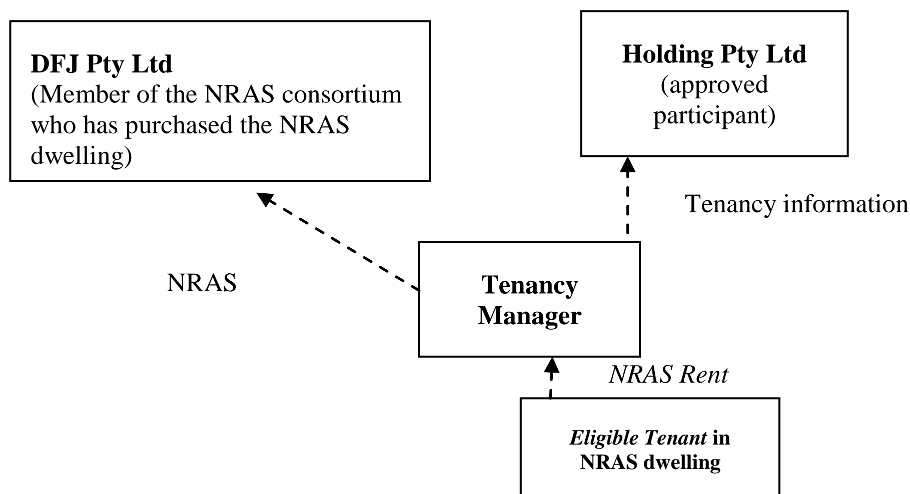
As outlined in ATO ID 2009/146, in this situation the manager, Affordable Rental Solutions Company, is deriving NRAS rent and the individual dwelling owner is deriving ordinary rent. As such, the manager would be the entity eligible for the NRAS tax offset.

See paragraphs 3.52 to 3.75 on the election available for the manager to pass the incentive on to the dwelling owner.

Example 3.4: NRAS rent derived by the owner of the rental dwelling

ABC Group is an NRAS consortium comprising an approved participant (Holding Pty Ltd), a tenancy manager (Real Estate Pty Ltd) and the owner of a rental dwelling (DFJ Pty Ltd).

Under this NRAS consortium, the tenancy manager has the responsibility of managing the rental property and the approved participant has the responsibility of engaging with the DSEWPaC in regard to the NRAS obligations. Rent from the NRAS dwelling is paid through the tenancy manager directly to the owner of the rental dwelling and is considered to be NRAS rent paid to the owner.



As DFJ Pty Ltd has derived NRAS rent, it will be eligible to a tax offset for an income year if a certificate has been issued to the approved participant in relation to the NRAS dwelling and the income year begins in the NRAS year to which the certificate relates.

Certificates issued by the Housing Secretary

3.36 The approved participant will have notified the DSEWPaC of its role as representative of an NRAS consortium. In practice, the Housing Secretary will issue an NRAS certificate to the approved participant (which may be the manager) of an NRAS consortium. ***[Schedule 3, item 16, subsection 995-1(1)]***

3.37 Certificates are issued to the approved participant regardless of whether the approved participant is the entity directly deriving NRAS rent.

3.38 A certificate issued under the NRAS in relation to the NRAS dwelling is a requirement that needs to be satisfied for a consortium member to be entitled to the NRAS tax offset under section 380-10. However, the certificate is not required to be issued to the same entity claiming the NRAS tax offset under section 380-10, it is simply required to be issued.

Amount of the tax offset

3.39 Members of an NRAS consortium are entitled to the portion of the total amount of the tax offset stated for each NRAS dwelling (stated in the certificate issued to the approved participant of the NRAS consortium), which is equal to their portion of the total NRAS rent derived from the NRAS dwelling during the NRAS year. ***[Schedule 3, item 1, subsection 380-10(2)]***

3.40 In cases where only one member derives NRAS rent for an NRAS dwelling, that member will be entitled to the full amount stated in the certificate for that NRAS dwelling. Likewise, in cases where there are two members who have been deriving the NRAS rent in the ratio 30:70, the member deriving 30 per cent of the NRAS rent will be entitled to 30 per cent of the incentive stated in the certificate for the NRAS dwelling and the member deriving 70 per cent of the NRAS rent will be entitled to 70 per cent of the incentive stated in the certificate.

3.41 If the Housing Secretary issues an amended certificate, references to an NRAS certificate will be treated as a reference to an amended NRAS certificate. In practice, this will mean that once an amended certificate is issued it takes the place of the original certificate. ***[Schedule 3, item 2, section 380-32]***

Example 3.5: Calculating the amount of the tax offset

> HP is a member of an NRAS consortium who is entitled to an NRAS tax offset. HP derives $12,000 of NRAS rent from the NRAS dwelling for the 2010-11 NRAS year. $12,000 is the total amount of NRAS rent derived from the NRAS dwelling for the 2010-11 NRAS year and therefore HP is the only entity deriving NRAS rent from the NRAS dwelling in the 2010-11 NRAS year.
>
> The certificate issued in relation to the NRAS dwelling indicates an incentive of $6,000 for the NRAS dwelling for the 2010-11 NRAS year.
>
> HP will be entitled to a tax offset of **$6,000** (6,000 × (12,000/12,000)).

3.42 In cases where the NRAS certificate represents only part of the NRAS year and as such the incentive amount in the certificate has been apportioned for that period, members must work out their entitlement based on that period to which the certificate relates. ***[Schedule 3, item 1, subsection 380-10(3)]***

3.43 Under the NRAS, approved participants that are endorsed charitable institutions will receive the NRAS incentive as a payment

unless they elect to receive the incentive as a tax offset. Certificates are only issued for the purposes of the tax offset.

3.44 In certain situations where the approved participant has changed their status throughout the NRAS year (for example, from an endorsed charitable institution to another eligible approved participant), the Housing Secretary may make a payment for NRAS dwellings in relation to part of the NRAS year and also issue a certificate for the NRAS dwellings in relation to the other part of the NRAS year. (The provisions that determine the situation where this may occur are outlined in Regulation 29 of the *National Rental Affordability Scheme Regulations 2008*.)

3.45 In cases where a certificate is issued, in addition to a direct payment for the NRAS dwelling being made by the DSEWPaC, members must work out their entitlement to the tax offset amount listed in the certificate with reference to the time period covered by the certificate.

Example 3.6: Calculating the amount of the tax offset — certificate covering part of the NRAS year

HP is a member, but not the approved participant, of an NRAS consortium who is entitled to an NRAS tax offset. HP derives $12,000 of NRAS rent from the NRAS dwelling for the 2010-11 NRAS year. $12,000 is the total amount of NRAS rent derived from the NRAS dwelling for the 2010-11 NRAS year and therefore HP is the only entity deriving NRAS rent from the NRAS dwelling in the 2010-11 NRAS year.

During the NRAS year the approved participant changes and as a result a direct payment and an NRAS certificate is issued in relation to the NRAS dwelling. The certificate issued in relation to the NRAS dwelling indicates an incentive of $2,000 for the NRAS dwelling (the certificate covers four months of the year). An additional $4,000 is paid directly to the approved participant.

The amount of NRAS rent derived by HP over the four-month period to which the certificate relates equals $4,000.

HP will be entitled to a tax offset of **$2,000** (2,000 × (4,000/4,000)) and will receive the $4,000 incentive paid directly to the approved participant.

Regardless of whether the approved participant changes throughout the NRAS year, HP will be entitled to the full incentive related to the NRAS dwelling. This is because HP is the only entity deriving NRAS rent from the NRAS dwelling for the full NRAS year.

Special rules for partnerships and trustees that are members but not the approved participant

3.46 If the member of the NRAS consortium is a partnership or a trustee of a trust (and the member is not the approved participant) and the following conditions are satisfied:

- a certificate has been issued in relation to an NRAS year to the approved participant;
- the NRAS certificate covers one or more NRAS dwellings; and
- the member has derived NRAS rent during the NRAS year from any of the NRAS dwellings,

then it must be assumed for sections 380-15 and 380-20 of the ITAA 1997 that the member (rather than the approved participant) has been issued with a certificate in relation to the NRAS year that covers the dwellings for which the member has NRAS rent. The amount stated in the certificate is the total amount that the member is eligible to receive in relation to the dwellings. ***[Schedule 3, item 1, section 380-14]***

3.47 NRAS rent may flow indirectly to entities via a partnership or a trust. Entities that receive the NRAS rent indirectly are entitled to an offset if certain conditions are satisfied.

3.48 An entity is entitled to a tax offset for an income year (offset year) if:

- a certificate has been issued in relation to an NRAS year to the partnership or trustee of the trust;
- the NRAS certificate covers one or more NRAS dwellings;
- the offset year for the partnership or trustee begins in the NRAS year;
- NRAS rent derived from any of the NRAS dwellings during the NRAS year flows indirectly to the entity in any income year; and
- the entity is one of the following: an individual; a corporate tax entity when the NRAS rent flows indirectly to it; the trustee of a trust that is liable to be assessed on a share of, or all or a part of, the trust's net income under the *Income Tax Assessment Act 1936*; the trustee of an First Home Savers

Account; a superannuation fund; an approved deposit fund; or a pooled superannuation trust.

[Schedule 3, item 1, subsection 380-15]

Amount of the tax offset

3.49 The entity to which the NRAS rent flows indirectly via a partnership or a trust is entitled to a tax offset equal to the portion of the total amount stated for each NRAS dwelling in the certificate which is equal to the portion of the entity's share of total NRAS rent for the NRAS dwelling during the NRAS year. ***[Schedule 3, item 1, subsection 380-15(2)]***

3.50 In cases where the NRAS certificate represents only part of the NRAS year and as such the incentive amount in the certificate has been apportioned for that period, entities will also work out their entitlement based on that period to which the certificate relates. ***[Schedule 3, item 1, subsection 380-15(3)]***

3.51 Minor amendments have been made to ensure the structure of provisions is consistent. ***[Schedule 3, item 1, sections 380-5 and 380-20]***

Election to allow investors not deriving NRAS rent to receive the tax offset

Approved participants who are individuals, corporate tax entities or a superannuation fund

3.52 Given that the eligibility to the tax offset is triggered by deriving NRAS rent, this election provides the approved participant deriving NRAS rent with a mechanism to transfer the tax offset to the ultimate investor where the structures adopted result in the investor deriving rent that cannot be characterised as NRAS rent.

3.53 As discussed in paragraph 3.34, NRAS consortiums may be structured in many ways. In the case where a head lease (between the investor and the manager) and a sublease (between the manager and the eligible tenant) exists, the manager of the rental dwellings will be the entity deriving NRAS rent and will therefore be entitled to the tax offset.

3.54 In these cases, the NRAS approved participant of an NRAS consortium may make an irrevocable election to ensure that a member of the NRAS consortium is entitled to a portion of the tax offset that the NRAS approved participant would otherwise be entitled equal to the member's rent portion of the total rent. ***[Schedule 3, item 4, subsections 380-11(1) and (4) and 380-12(1) and (2)]***

3.55 The ***member's rent*** would be the rent derived by the member (indirectly) from the NRAS dwelling during the income year and the ***total rent*** would be the rent derived from the NRAS dwelling during the NRAS year. ***[Schedule 3, item 4, section 380-12]***

3.56 In practice, the member may have an agreed practice with the approved participant where the approved participant takes fees out of the NRAS rent it derives before passing on the ordinary rent to the member.

3.57 The definition of 'members rent' is the rent derived by the member from the NRAS dwelling and as such will consist of the actual amount passed on to the member plus any amounts taken out by the approved participant by virtue of any additional agreements between the parties, if that amount taken out would be included in the assessable income of the member.

3.58 If the NRAS dwelling was only eligible for the NRAS offset for part of the income year, then the member's rent or total rent relates to that part of the year that the NRAS dwelling was eligible to receive the NRAS offset. ***[Schedule 3, item 4, subsection 380-12(4)]***

3.59 In essence, the election will pass the entitlement from the approved participant on to the member deriving the ordinary rent indirectly from the NRAS dwelling. As such, the approved participant's tax offset entitlement under the standard provisions (section 380-10) will be reduced by the same amount as the amount passed on to the member via the election. ***[Schedule 3, item 4, subsection 380-12(3)]***

3.60 Disregard from total rent any rent derived by an approved participant which is then passed on to another member by virtue of contractual arrangements that establish the NRAS consortium. ***[Schedule 3, item 4, subsection 380-12(5)]***

3.61 Any NRAS rent retained by the approved participant as management fees or commission will be treated as being passed on to the other member. ***[Schedule 3, item 4, subsection 380-12(6)]***

3.62 Amendments ensure that the election links into the flow-through provisions which apply when the tax offset is 'transferred' to a trustee or partnership. ***[Schedule 3, item 4, section 380-13]***

Approved participants who are partnerships or trustees

3.63 Approved participants who are partnerships and trustees of trusts can also make an irrevocable election to have an entitlement to a tax offset (by virtue of NRAS rent derived by the approved participant flowing indirectly to an entity in an income year) transferred to another member

deriving rent from the NRAS dwelling during the NRAS year. ***[Schedule 3, item 6, section 380-16]***

3.64 If the entity to which the entitlement to the tax offset is transferred is an individual, a corporate tax entity or a superannuation fund, then the amount of the tax offset to which the entity is entitled will be the portion of the total tax offsets equal to the member's rent portion of total rent. ***[Schedule 3, item 6, section 380-17]***

3.65 Member's rent and total rent have the same meaning as in paragraph 3.55. ***[Schedule 3, item 6, subsection 380-17(2)]***

3.66 Again, disregard from the total rent any rent derived by an approved participant which is then passed on to another member by virtue of a contractual arrangement that established the NRAS consortium. ***[Schedule 3, item 6, subsection 380-16(5)]***

3.67 Any NRAS rent retained by the approved participant as management fees or commission will be treated as being passed on to the other member. ***[Schedule 3, item 6, subsection 380-16(6)]***

3.68 ***Total tax offset*** means the total of offsets to which entities would be entitled because the NRAS rent derived from the NRAS dwelling covered by the certificate flows indirectly to them from the approved participant. ***[Schedule 3, item 6, subsection 380-16(2)]***

3.69 The tax offset to which an entity to which NRAS rent derived from the NRAS dwelling flows indirectly is reduced because of the election. The offset is reduced by the proportion of the tax offset entitlement transferred that equals the proportion of the entities original tax offset to the total tax offsets. ***[Schedule 3, item 6, subsection 380-16(2)]***

3.70 These amendments ensure that the election by a partnership or trustee approved participant links into the flow-through provisions in sections 380-15 and 380-20 to 380-30 where the tax offset is 'transferred' to a another trustee or partnership. ***[Schedule 3, item 6, section 380-18]***

Requirements for elections

3.71 The election must be made in the approved form and within 30 days after the day the Housing Secretary issues the certificate to the NRAS approved participant. ***[Schedule 3, item 4, subsections 380-11(2) and 380-16(2)]***

3.72 If an amended certificate is issued by the Housing Secretary, the election will be required to be made within 30 days after the amended certificate is issued. ***[Schedule 3, item 2, section 380-32]***

3.73 The Commissioner may require that a copy of the election be given to the Commissioner and/or to each member of the NRAS consortium who may be entitled to a tax offset as a result of the election being made. ***[Schedule 3, item 4, subsections 380-11(3) and 380-16(3)]***

3.74 Allowing the Commissioner to require that a copy of the election be given to members aids in the administration of the NRAS and will provide notification/assistance to those members entitled to the NRAS offset by virtue of the election being made.

3.75 The Commissioner may choose not to require a copy of the election to be provided and may instead require that approved participants simply make an election and retain that election until an audit is performed when the election will need to be evidenced.

Example 3.7

An NRAS consortium is established that includes the dwelling owners and the manager of the consortium. The approved participant of the consortium is the manager. The manager applies to the Housing Secretary to participate in the NRAS and represents the parties to the consortium.

The dwelling owners enter into a head lease with the manager of the consortium. The manager of the consortium then enters into a sublease with NRAS eligible tenants (being low to moderate income households).

Under this arrangement, it is the manager (approved participant) of the NRAS consortium that derives NRAS rent from the eligible tenants under the sublease. The dwelling owners derive ordinary rent (not NRAS rent) from the manager under the head lease.

These facts are identical to those addressed by ATO ID 2009/146 (with the references to 'non-entity joint venture' replaced by 'NRAS consortium').

Following the completion of the NRAS year, the Housing Secretary issues the manager representing the consortium with a certificate in relation to the rental dwelling.

If an election is not made, the manager would be entitled to a tax offset, as the manager is the entity deriving NRAS rent. The dwelling owners, having not derived any NRAS rent, would not be entitled to a tax offset. This is not NRAS rent for the reasons given in ATO ID 2009/146.

Alternatively, the parties to the consortium may have predicated their participation in the NRAS on the basis that the NRAS incentive would be enjoyed by the dwelling owners, rather than the manager. To

achieve this outcome, following receipt of the certificate from the Housing Secretary, the manager may elect to relinquish its entitlement to a tax offset for the income year corresponding to the NRAS year covered by the certificate. The manager is eligible to make this election because it is entitled to a tax offset under section 380-10 of the ITAA 1997 and it is the approved participant in relation to the NRAS consortium.

If the manager makes the election, each party's entitlement to the NRAS tax offset for a dwelling would be in proportion to their share of the ordinary rent derived in relation to that dwelling, for the time in the NRAS year covered by the certificate in which the dwelling was eligible for the NRAS incentive. In this example, the ordinary rent derived from a rental dwelling means the rent derived by a dwelling owner under the head lease (that is, the rent derived by the dwelling owner from the manager of the consortium). Although this is not NRAS rent, it is rent ultimately sourced from the NRAS rent derived by the manager.

In this example, the dwelling owners are the ultimate recipients of all of the rent in respect of the property, under the head lease. Each dwelling owner therefore would be entitled to a portion of the tax offset but only if the election is made. The manager, having made the election, and not being the ultimate recipient of any rent in respect of the dwelling, is no longer entitled to any tax offset.

Payments made by states and territories

3.76 NRAS-related payments made (and non-cash benefits provided) by a state or territory government are non-assessable non-exempt income. ***[Schedule 3, item 10, section 380-35]***

3.77 This is the case whether such payments are received by a taxpayer directly or indirectly (for example, from another member of their NRAS consortium). ***[Schedule 3, item 10, section 380-35]***

3.78 Likewise, a capital gain or capital loss made from a CGT event relating directly to anything of economic value provided directly or indirectly by a state or territory government in relation to the participation in the NRAS is disregarded. ***[Schedule 3, item 9, paragraph 118-37(1)(j)]***

Example 3.8: Treatment of a state government NRAS-related payment received indirectly by the taxpayer

Mr Smith is part of the XYZ Housing Group, an NRAS consortium providing 400 rental dwellings under the NRAS across South Australia. Mr Smith owns one of these dwellings.

The South Australian Government elects to make its contribution to the NRAS incentive through a cash payment. In the case of NRAS consortiums, the South Australian Government makes a single cash payment to the approved participant of the consortium, in respect of all of the dwellings operated by the consortium which are eligible for an NRAS incentive.

In 2010-11, all of XYZ Housing Group's dwellings are eligible for the full NRAS incentive. Accordingly, the South Australian Government makes a payment in May 2011 to the approved participant of XYZ Housing Group of $914,000 (that is, $2,285 × 400).

This amount is non-assessable non-exempt income in the hands of the approved participant of XYZ Housing Group.

The practice of XYZ Housing Group is to have the economic benefit of the NRAS incentive flow to the individual dwelling owners. Accordingly, in May 2011 the manager makes a payment of $2,285 to Mr Smith.

This amount is an NRAS-related payment made by a state government which is received indirectly by Mr Smith. Therefore, it is non-assessable, non-exempt income.

Application and transitional provisions

3.79 Item 10, which amends the treatment of state and territory payments, applies to the 2008-09 income year and later income years. ***[Schedule 3, item 11]***

3.80 The following items will apply retrospectively for the benefit of affected taxpayers.

3.81 Item 1, which introduces the concept of an NRAS consortium and recognises that certificates are issued to the approved participant of the consortiums rather than to the consortiums directly, applies to the 2009-10 income year and later income years. ***[Schedule 3, item 3]***

3.82 Items 4 and 6, which provide an optional election for certain taxpayers, applies to the 2010-11 income year and later income years. ***[Schedule 3, item 7]***

3.83 An election in relation to an NRAS certificate may be made within 30 days after the day the amendment receives Royal Assent, if the Housing Secretary has already issued the NRAS certificate for the NRAS year 2010-11 before that date. ***[Schedule 3, item 8]***

Consequential amendments

3.84 There are consequential amendments made as a consequence of the technical amendments. The consequential amendments also clarify the meaning of the terms connected to the NRAS. ***[Schedule 3, items 5, 12, 13 and 15]***

Chapter 4
Phasing out the dependent spouse tax offset

Outline of chapter

4.1 Schedule 4 to this Bill amends the *Income Tax Assessment Act 1936* (ITAA 1936) to restrict eligibility for the dependent spouse tax offset to taxpayers with a dependent spouse born before 1 July 1971.

4.2 This Schedule also ensures that taxpayers eligible for the zone, overseas forces or overseas civilian tax offsets, or whose dependent spouse is a carer, an invalid or permanently unable to work, are not affected by this measure.

Context of amendments

4.3 The Treasurer announced in the 2011-12 Budget that the Government will phase out the dependent spouse tax offset for dependent spouses who are aged less than 40 on 1 July 2011, to help encourage more Australians into paid employment.

4.4 The reform is intended to remove the disincentive for younger dependent spouses without children to remain out of the workforce, and forms part of the Government's *Building Australia's Future Workforce* package.

4.5 The dependent spouse tax offset originated in the initial ITAA 1936. It is one of a number of tax offsets in section 159J of the ITAA 1936 for taxpayers that maintain particular types of dependant. Other examples are the invalid relative tax offset, parent/parent-in-law tax offset and the child-housekeeper tax offset.

4.6 The maximum dependent spouse tax offset was $2,286 in 2010-11 and will be $2,355 in 2011-12. The maximum amount of offset is indexed each year with reference to the All Groups Consumer Price Index number in accordance with section 159HA of the ITAA 1936.

4.7 The amount of offset reduces by $1 for every $4 by which the adjusted taxable income of the dependent spouse exceeds $282. That is, the effective tax rate on the first $10,000 earned by a spouse is around

25 per cent, meaning that dependent spouses, often women, face the prospect of being penalised for doing some part time work. The taxpayer is entitled to the maximum offset if the dependent spouse has adjusted taxable income of $282 or less. In 2010-11, a dependent spouse could have adjusted taxable income of $9,426 and the taxpayer would receive some offset.

4.8 Taxpayers cannot claim the dependent spouse tax offset for any part of the income year that they are a member of a Family Tax Benefit (Part B) family without shared care, or parental leave pay is payable to the taxpayer or their spouse, pursuant to section 159JA of the ITAA 1936.

4.9 Taxpayers are also not entitled to the dependent spouse tax offset if their adjusted taxable income is more than the 'income limit for Family Tax Benefit (Part B)'. ***Income limit for Family Tax Benefit (Part B)*** is defined as the 'amount specified in subclause 28B(1) of Schedule 1 to the *A New Tax System (Family Assistance) Act 1999*, as indexed under Part 2 of Schedule 4 to that Act'.

4.10 The amount of dependent spouse tax offset is relevant in determining the amount of other concessional tax offsets to which a taxpayer is entitled. These other tax offsets are the:

- zone tax offset (section 79A of the ITAA 1936): which is available to residents of remote or isolated locations that are prescribed in Schedule 2 to the ITAA 1936;
- overseas forces tax offset (section 79B of the ITAA 1936), which is available to Australian Defence Force personnel who have served at overseas locations that have been specified by the Treasurer pursuant to subsection 79B(5) of the ITAA 1936; and
- overseas civilian tax offset (section 23AB of the ITAA 1936): which is available to personnel that have served overseas under the control of the United Nations and are prescribed in Regulation 6 of the *Income Tax Regulations 1936*.

4.11 Recipients of the zone, overseas forces or overseas civilian tax offsets receive a base amount of offset. In addition, they also receive up to 50 per cent of any dependency tax offsets to which they are entitled that are or were provided for in section 159J of the ITAA 1936. These offsets are described as the 'relevant rebate amount' for the purposes of the zone tax offset and 'concessional rebate amount' for the purposes of the overseas forces tax offset. In addition, eligible taxpayers receive an amount of dependent spouse tax offset under section 159J.

4.12 The amounts of dependency tax offset relevant to the calculation of a taxpayer's zone, overseas forces or overseas civilian tax offset amount include 'notional' dependency tax offsets. These are offsets that were previously available to taxpayers maintaining certain types of dependants but have been repealed in their own right.

4.13 Examples are the offset for taxpayers maintaining a full-time student aged less than 25 and the offset for a child aged less than 21 (not being a student). These offsets are allowed for in the table in subsection 159J(2) but, from 1 July 1976, they have not been able to be claimed by taxpayers pursuant to subsection 159J(1A).

4.14 Subsection 159J(1B) provides for an increased child-housekeeper tax offset if the taxpayer would have been entitled to an offset in respect of a dependent full-time student or child less than 21 (not being a student) but for the fact those offsets have not been claimable from 1 July 1976. In 2010-11, the amount of this child-housekeeper (with child) offset was $2,232 and it will be $2,299 in 2011-12.

4.15 For taxpayers maintaining a dependent spouse, who would have also been entitled to the child or student offset if those offsets still existed, there is a 'notional' dependent spouse (with child) offset. This offset is a higher amount than the dependent spouse tax offset.

4.16 The maximum 'notional' dependent spouse (with child) offset is indexed in accordance with section 159HA. In 2010-11, the maximum amount was $2,656 and it will be $2,736 in 2011-12.

4.17 The base amount for the purposes of the overseas forces and overseas civilian tax offsets is $338 and the taxpayer is also entitled to 50 per cent of their dependency tax offsets entitlements as a component of their offset.

4.18 Taxpayers eligible for the zone tax offset may receive three different base amounts depending on the zone in which they reside. The zones are Zone A, Zone B and 'special areas' within zones. 'Special areas' are defined in subsection 79A(3D) of the ITAA 1936 and comprise points in Zone A or Zone B that are more than 250 kilometres from the centre point of the nearest urban centre with a census population of more than 2,500 as at 1 November 1981.

4.19 Taxpayers residing in Zone A with a dependent spouse are eligible for up to $338 plus 50 per cent of their dependency tax offsets entitlement as a component of their offset.

4.20 Taxpayers residing in Zone B with a dependent spouse are eligible for up to $57 plus 20 per cent of their dependency tax offsets

entitlement. Taxpayers residing in 'special areas' within Zone A or Zone B are eligible for up to $1,173 plus 50 per cent of their dependency offsets entitlement.

4.21 As noted above, section 159J of the ITAA 1936 provides for a number of offsets that assist taxpayers who maintain particular types of dependants. These include the invalid relative tax offset which is available to taxpayers who maintain an 'invalid relative' as defined in subsection 159J(6).

4.22 ***Invalid relative*** means a person aged 16 or more who is a child (including an adopted child, step-child or ex-nuptial child), brother or sister of the taxpayer. The person must be in receipt of a disability support pension or a special needs disability support pension or have been certified by certain professionals as having a continuing inability to work.

4.23 The certificate must have been issued for the purpose of examining the dependant's eligibility for disability support pensions under the *Social Security Act 1991* (Cth) by:

- a medical officer of the 'Health Department', being the department that deals with matters arising under section 1 of the *National Health Act 1953* (Cth) that is administered by the 'Health Minister', being the Minister who administers section 1 of the *National Health Act 1953* (Cth); or

- a medical practitioner appointed by the 'Families Secretary', being the Secretary of the department that deals with matters arising under the *A New Tax System (Family Assistance) (Administration) Act 1999* (Cth) that is administered by the 'Families Minister', being the Minister administering section 1 of the *A New Tax System (Family Assistance) (Administration) Act 1999* (Cth).

4.24 The 'invalid relative' definition does not currently include a dependent spouse of the taxpayer. The definition also does not include the brother, sister or child of a spouse of the taxpayer. The maximum invalid relative tax offset amount in 2010-11 is $839. The maximum amount of this offset is indexed each year with reference to the All Groups Consumer Price Index number in accordance with section 159HA of the ITAA 1936.

Summary of new law

4.25 From 1 July 2011, taxpayers with a dependent spouse born on or after 1 July 1971 will no longer be entitled to claim the dependent spouse tax offset. This means the dependent spouse tax offset will be gradually phased out as the population ages to remove disincentives to enter the workforce for younger dependent spouses without children.

4.26 In recognition of the limited employment opportunities for some dependent spouses, taxpayers maintaining a dependent spouse born on or after 1 July 1971 who is an invalid or permanently unable to work or providing care, will remain entitled to claim an amount equivalent to the dependent spouse tax offset in respect of a dependent 'invalid spouse' or dependent 'carer spouse'.

4.27 Taxpayers with a dependent spouse born on or after 1 July 1971 who are eligible for the zone, overseas forces or overseas civilian tax offsets will remain eligible for an amount equivalent to the dependent spouse tax offset as a component of their zone, overseas forces or overseas civilian tax offset. This is in recognition of limited employment opportunities that may exist in remote or isolated regions or if a person's spouse is deployed overseas.

4.28 Taxpayers eligible for the zone, overseas forces or overseas civilian tax offsets would also continue to be entitled to either 20 or 50 per cent of their dependent spouse tax offset entitlement as though no age restriction applied. The proportion of dependent spouse tax offset entitlement that could be claimed would continue to be higher if the taxpayer was eligible for the notional child or student offsets.

4.29 Because of their continuing eligibility for the dependent spouse tax offset, taxpayers with a dependent spouse born before 1 July 1971 will only be entitled to an amount equating to 50 per cent of their dependent spouse tax offset entitlement as part of their zone, overseas forces or overseas civilian tax offset (or 20 per cent if they are a resident of Zone B).

4.30 By contrast, taxpayers with a dependent spouse born on or after 1 July 1971 would be entitled to the relevant proportion of their dependent spouse tax offset entitlement, assuming no age restriction applied. In addition, the taxpayer could claim the full amount of this dependent spouse tax offset entitlement as a component of their zone, overseas forces or overseas civilian tax offset.

4.31 If a taxpayer is entitled to the dependent spouse tax offset in respect of a dependent spouse born before 1 July 1971, they will not be entitled to claim the equivalent amount in respect of an 'invalid spouse' or

a 'carer spouse'. Taxpayers will also not be entitled to claim an amount in respect of a 'carer spouse' if they have already claimed an amount in respect of an 'invalid spouse'.

4.32 Taxpayers eligible for more than one of the zone, overseas forces or overseas civilian tax offsets will not be able to claim more than the full amount of offset in respect of a dependent spouse across each offset. That is, a taxpayer will not be able to receive more than their maximum dependent spouse entitlement if they have eligibility for both an amount of zone and overseas forces tax offset.

Comparison of key features of new law and current law

New law	*Current law*
Taxpayers are not entitled to claim the dependent spouse tax offset in respect of a dependent spouse born on or after 1 July 1971.	Taxpayers are entitled to claim the dependent spouse tax offset in respect of a dependent spouse regardless of the spouse's age.
Taxpayers will continue to be entitled to an amount equivalent to their dependent spouse tax offset entitlement as though no age restriction applies, as a component of their zone, overseas forces or overseas civilian tax offset amount.	Taxpayers are not entitled to receive the full amount of their dependent spouse tax offset entitlement as a component of their zone, overseas forces or overseas civilian tax offset amount.
Taxpayers maintaining a dependent spouse who is an invalid or permanently unable to work or unable to work due to caring responsibilities will continue to be entitled to an amount equivalent to their dependent spouse tax offset entitlement as though no age restriction applies through an amended invalid relative tax offset.	Taxpayers are not entitled to claim an amount of invalid relative tax offset in respect of a dependent spouse who is an invalid or permanently unable to work, or a spouse who has caring responsibilities or receives certain carer payments.

Detailed explanation of new law

4.33 These amendments give effect to the 2011-12 Budget measure to phase out eligibility for the dependent spouse tax offset for taxpayers who maintain a dependent spouse born on or after 1 July 1971 but to retain eligibility for an amount equivalent to the dependent spouse tax offset entitlement as though no age restriction applies for particular taxpayers.

4.34 The amendments to section 23AB ensure that taxpayers eligible for the overseas civilian tax offset remain entitled to claim an amount equivalent to 50 per cent of their dependent spouse tax offset entitlement as though the age restriction does not apply. ***[Schedule 4, item 1, sub-subparagraph 23AB(7)(a)(ii)(D)]***

4.35 The current disregard of section 159JA of the ITAA 1936 will continue to apply. That is, a taxpayer will be entitled to 50 per cent of their dependent spouse tax offset entitlement, assuming no age restriction applies and also that there is no rule in section 159JA that precludes the taxpayer from claiming the dependent spouse tax offset while they are a member of a Family Tax Benefit (Part B) family or the taxpayer or their spouse is in receipt of parental leave pay.

4.36 Further, if the taxpayer maintains a dependent spouse born on or after 1 July 1971 and also maintains a child under 21 (not being a student) or a full-time student under 25, they will be entitled to 50 per cent of the higher, 'notional' dependent spouse (with child) offset amount.

4.37 For ease of understanding, these assumptions will be included in a new subsection 23AB(7A). The assumptions are the disregard of section 159JA, disregard of subsection 159J(1C) and assumed amendment of the wording in subsection 159J(1B) and the table in subsection 159J(2). ***[Schedule 4, item 3, subsection 23AB(7A)]***

4.38 The amendments also mean that taxpayers eligible for the overseas civilian tax offset who are maintaining a dependent spouse born on or after 1 July 1971 remain entitled to claim the full amount of dependent spouse tax offset, assuming no age restriction applies, as a component of their overseas civilian tax offset amount. ***[Schedule 4, item 2, subparagraph 23AB(7)(a)(iii)]***

4.39 That is, taxpayers eligible for the overseas civilian tax offset who are maintaining a dependent spouse born on or after 1 July 1971, will be entitled to up to $338 as their base amount plus the full amount of dependent spouse tax offset as though no age restriction applies. They will also be entitled to 50 per cent of their dependent spouse tax offset amount, assuming no age restriction applied, section 159JA did not apply and other amendments had been made to section 159J.

4.40 The amendments to section 79A ensure that taxpayers eligible for the zone tax offset remain entitled to either 20 or 50 per cent of their dependent spouse tax offset entitlement as though no age restriction applies. Further, zone tax offset recipients with a dependent spouse will be entitled to claim the 'dependent spouse relevant rebate amount' as a component of their zone tax offset amount. ***[Schedule 4, item 4, paragraphs 79A(2)(a), (d) and (e)]***

4.41 The ***dependent spouse relevant rebate amount*** is defined as the amount of dependent spouse tax offset that a taxpayer is eligible for, assuming no age restriction applied. ***[Schedule 4, item 5, subsection 79A(4)]***

4.42 A taxpayer's 'relevant rebate amount' is amended so that the age restriction is disregarded in determining the dependent spouse tax offset component of this amount. This means that, for example, a taxpayer with a dependent spouse born on or after 1 July 1971, who is also maintaining a child under 21 (not being a student), will be eligible for the relevant proportion of the 'notional' dependent spouse (with child) tax offset as part of their zone tax offset entitlement. ***[Schedule 4, item 6, subsection 79A(4)]***

4.43 The amendments to subsection 79B(2) ensure that taxpayers entitled to the overseas forces tax offset remain eligible for their dependent spouse tax offset entitlement as though the age restriction did not apply. ***[Schedule 4, items 7 and 8, subparagraphs 79B(2)(a)(ii) and (iii)]***

4.44 The amendments to subsection 79B(4) mean that taxpayers entitled to the overseas forces tax offset and either the overseas civilian tax offset or zone tax offset, may receive up to an amount equivalent to their dependent spouse tax offset entitlement as though no age restriction applies, as well as $338 plus 50 per cent of their 'concessional rebate amount'. ***[Schedule 4, items 9 and 10, subsection 79B(4)]***

4.45 A taxpayer will not be eligible for an amount of overseas forces tax offset if they are entitled to the zone tax offset and the amount of their zone tax offset is greater than $338 plus 50 per cent of the taxpayer's 'concessional rebate amount' plus the full amount of dependent spouse tax offset entitlement disregarding the age restriction. ***[Schedule 4, item 11, subsection 79B(4A)]***

4.46 To ensure taxpayers maintaining a spouse born on or after 1 July 1971 remain entitled to 50 per cent of their dependent spouse tax offset amount, assuming the age restriction does not apply, an amendment is made to the definition of 'concessional rebate amount'. ***[Schedule 4, item 12, subsection 79B(6)]***

4.47 There is also an amendment to insert a definition of ***dependent spouse concessional rebate amount***, being an amount of dependent spouse tax offset that a taxpayer would be eligible for if the age restriction did not apply. ***[Schedule 4, item 13, subsection 79B(6)]***

4.48 The maximum amount of dependent spouse tax offset and 'notional' dependency tax offsets are indexed in accordance with section 159HA of the ITAA 1936. In response to the inclusion of the 'notional' dependent spouse with child component of the overseas civilian tax offset in new subsection 23AB(7A), there is a need to update the

section reference of the amount to be indexed in the 'indexable amount' definition in section 159HA. ***[Schedule 4, item 14, subsection 159HA(7)]***

4.49 The amendments then give effect to the Government decision to phase out the dependent spouse tax offset for taxpayers with a dependent spouse born on or after 1 July 1971. ***[Schedule 4, item 15, subsection 159J(1C)]***

4.50 The amendments also ensure that if a taxpayer is entitled to claim the dependent spouse tax offset in respect of a dependent spouse born before 1 July 1971, they are not also entitled to claim an amount in respect of an 'invalid spouse' or a 'carer spouse'. ***[Schedule 4, item 15, subsection 159J(ID)]***

4.51 Further, the amendments ensure that a taxpayer entitled to claim an amount in respect of an 'invalid spouse' is not also able to claim an amount in respect of that same spouse as a 'carer spouse'. ***[Schedule 4, item 15, subsection 159J(1E)]***

4.52 A taxpayer's 'invalid spouse' or 'carer spouse' are included in class 5 of the table in subsection 159J(2) of the ITAA 1936. As a result, the existing invalid relative tax offset is extended to include two new amounts that equate to the amount of dependent spouse tax offset in class 1. These amounts will be able to be claimed by taxpayers maintaining a 'carer spouse' or an 'invalid spouse'. ***[Schedule 4, item 16, subsection 159J(2) (item 5 in the table)]***

4.53 The amount of offset included in the table for an 'invalid spouse' or 'carer spouse' is $2,100. In accordance with section 159HA, this amount is deemed to have been indexed from 1 July 2008 so the maximum amount of the offsets is $2,355 in 2011-12. This amount will be indexed in accordance with section 159HA in future years.

4.54 There are amendments to subsection 159J(3) to reflect a drafting preference for 'or' to be added at the end of paragraphs. ***[Schedule 4, item 17, subsection 159J(3)]***

4.55 Further amendments to subsection 159J(3) mean that where a taxpayer maintains a dependent 'invalid spouse' or 'carer spouse' for part of the income year only, then part of the offset will be allowable to the taxpayer in respect of that dependant as is reasonable to the Commissioner of Taxation (Commissioner). ***[Schedule 4, item 18, subsection 159J(3)]***

4.56 The amendment to subsection 159J(3A) ensures that a person satisfying the definition of an 'invalid spouse' or 'carer spouse' of the taxpayer will be deemed to have domicile in Australia at all times that the taxpayer has domicile in Australia. That is, the taxpayer may maintain an 'invalid spouse' or 'carer spouse' who is not a resident of Australia but

still be entitled to claim an amount of offset in respect of that dependant. ***[Schedule 4, item 19, subsection 159J(3A)]***

4.57 New subsection 159J(5CA) is inserted to clarify that a reference to a dependant included in class 1 in the table in subsection (2) includes a reference to a person who is an 'invalid spouse' or 'carer spouse'. ***[Schedule 4, item 20, subsection 159J(5CA)]***

4.58 The amendments to subsection 159J(5D) ensure that a child of the taxpayer will be deemed not to have been engaged in keeping house for the taxpayer for any part of the year that the taxpayer is entitled to an offset in respect of a dependent 'invalid spouse' or a dependent 'carer spouse'. ***[Schedule 4, item 21, subsection 159J(5D)]***

4.59 Further, there are also amendments to subsection 159J(5D) to ensure a child of the taxpayer is deemed not to have been engaged in keeping house for the taxpayer for any part of the year that the taxpayer would have been entitled to a dependent spouse tax offset in respect of their spouse but for the operation of the age restriction in subsection 159J(1C). ***[Schedule 4, item 21, subsection 159J(5D)]***

4.60 ***Carer spouse*** is defined as a spouse of the taxpayer who is wholly engaged in providing care to an 'invalid relative', which includes an invalid relative of the taxpayer's spouse; or to whom a Carer Allowance, Carer Payment or Carer Service Pension is being paid. ***[Schedule 4, item 22, subsection 159J(6)]***

4.61 The amendments expand the 'invalid relative' definition so that it includes a child, brother or sister aged more than 16 years of the taxpayer's spouse as well as a child, brother or sister aged more than 16 years of the taxpayer. ***[Schedule 4, item 23, subsection 159J(6)]***

4.62 The definition of 'invalid spouse' is inserted into subsection 159J(6). ***Invalid spouse*** is defined as a spouse of the taxpayer who meets the requirements for disability and continuing inability to work that are currently imposed on an 'invalid relative', as defined in subsection 159J(6). ***[Schedule 4, item 24, subsection 159J(6)]***

4.63 That is, the 'invalid spouse' must be receiving a Disability Support Pension or Special Needs Disability Support Pension or have a certificate from an appropriate medical officer or medical practitioner as outlined in paragraph 4.23.

4.64 The amendment to subsection 159JA(1) of the ITAA 1936 adds a taxpayer's 'invalid spouse' or 'carer spouse' to the classes of dependants referred to in that subsection. As a result, if the taxpayer is a member of a Family Tax Benefit (Part B) family, or they or their 'invalid spouse' or 'carer spouse' is receiving parental leave pay, the taxpayer will be unable

to claim an offset for that part of the year in respect of the dependant. ***[Schedule 4, item 25, paragraph 159JA(1)(a)]***

4.65 A taxpayer's 'invalid spouse' or 'carer spouse' is also added to the classes of dependants in the formula calculating the offset allowable to taxpayers where shared care arrangements apply. ***[Schedule 4, item 26, paragraph 159JA(3)(b)]***

4.66 Consistent with drafting preferences, there are amendments to subsection 159L(1) to add the word 'or'. ***[Schedule 4, item 27, subsection 159L(1)]***

4.67 The amendments further revise subsection 159L(1) to confirm that a taxpayer may claim the housekeeper tax offset in respect of a housekeeper who is wholly engaged in keeping house in Australia for the taxpayer and in caring for an 'invalid spouse' or 'invalid relative'. ***[Schedule 4, item 28, subsection 159L(1)]***

4.68 As the definition of 'invalid spouse' includes a spouse receiving the Disability Support Pension, the amendments replace former paragraph 159L(1)(c) as it is no longer required. Former paragraph 159L(1)(c) allowed a taxpayer to claim the housekeeper tax offset in respect of a housekeeper who was wholly engaged in keeping house for the taxpayer in Australia and in caring for the taxpayer's spouse who was receiving a Disability Support Pension. ***[Schedule 4, item 29, paragraph 159L(1)(c)]***

4.69 The amendments mean that a housekeeper will be deemed to have not been wholly engaged in keeping house for the taxpayer, as required for the purposes of the housekeeper tax offset, during any part of the income year that the taxpayer is entitled to an offset in respect of a 'carer spouse'. ***[Schedule 4, item 30, subsection 159L(3)]***

4.70 There are amendments to subsection 159L(4) to clarify that a taxpayer is not entitled to claim the housekeeper tax offset if they have a spouse unless that spouse is an 'invalid spouse' or the Commissioner is of the opinion that it is just to allow an offset because of special circumstances. ***[Schedule 4, item 31, subsection 159L(4)]***

4.71 In response to the inclusion of 'invalid spouse' and 'carer spouse' as categories of dependants in class 5 in the table in subsection 159J(2), it is necessary to amend the definition of 'dependant' for the purposes of the net medical expenses tax offset in section 159P of the ITAA 1936. The amendment to the 'dependant' definition clarifies that paragraph (ca) only applies to an 'invalid relative'. An 'invalid spouse' or 'carer spouse' of the taxpayer would be captured by 'spouse of the taxpayer' in paragraph (a) of the definition. ***[Schedule 4, item 32, subsection 159P(4)]***

Application and transitional provisions

4.72 The restriction of eligibility for the dependent spouse tax offset in respect of dependent spouses born on or after 1 July 1971, and revisions to the zone, overseas forces and overseas civilian tax offsets and the invalid relative tax offset, take effect for the 2011-12 income year and later income years. ***[Schedule 4, item 34]***

Consequential amendments

4.73 The amendment to section 13-1 of the *Income Tax Assessment Act 1997*, which lists offsets that are claimable, includes the offset available in respect of a taxpayer's 'invalid spouse' or 'carer spouse' in the item in the table for 'invalid relative'. ***[Schedule 4, item 33, section 13-1]***

Chapter 5
Reform of the car fringe benefits rules

Outline of chapter

5.1 Schedule 5 to this Bill amends the *Fringe Benefits Tax Assessment Act 1986* to reform the current statutory formula method for determining the taxable value of car fringe benefits by replacing the current statutory rates with a single statutory rate of 20 per cent, regardless of kilometres travelled.

Context of amendments

5.2 A fringe benefit is, generally speaking, a benefit provided in respect of employment. Fringe benefits are provided to employees (or associates of employees) in place of, or in addition to, salary or wages.

5.3 A fringe benefit usually takes the form of non-money income, such as the use of a company car for private purposes, but can also involve cash, for example where an employee is reimbursed by their employer for private expenses.

5.4 The fringe benefits tax (FBT) law was introduced in 1986 to ensure that all forms of employee remuneration are taxed, whether provided as salary and wages or in a non-cash form.

5.5 Before the introduction of the FBT law in 1986, providing fringe benefits to employees became a major source of tax avoidance and evasion, in particular for high income earners.

5.6 A fringe benefit will arise where an employee is provided with a car for private use (this includes home to work travel).

5.7 Car fringe benefits are valued using either the operating cost method or the statutory formula method.

5.8 Under the operating cost method, the taxable value of the benefit is based on the cost of owning and operating the car, reduced by the portion which relates to the business use of the vehicle. Employers are required to substantiate the business use of the vehicle by maintaining a log book for a specified period.

5.9 Under the statutory formula method, the taxable value of the benefit is based on the cost of the car multiplied by the relevant statutory percentage, which depends on the number of kilometres that the car has travelled, taking into consideration the number of days in the year the car fringe benefits were provided by the employer.

5.10 The statutory formula method is designed to provide employers with a low compliance cost alternative to the operating cost method, eliminating the need to maintain a vehicle log book. The statutory formula method removes the need to explicitly distinguish between the business and private use of a vehicle.

5.11 Currently, the statutory formula method for valuing car benefits uses progressive statutory fractions. That is, as the number of kilometres during the FBT year increases, the value of the fringe benefits fall (and hence the tax burden applied to those benefits also falls), even though there has been no substantive change to the benefits being provided.

5.12 Underlying this approach is an assumption that as distance travelled increases; the business use of the vehicle also increases.

5.13 Originally, three statutory percentages were proposed (0.24 for less than 25,000 kilometres, 0.16 for 25,000 to 40,000 kilometres and 0.08 for over 40,000 kilometres) for valuing car fringe benefits.

5.14 However, on 29 May 1986, the then Treasurer announced that as a result of discussions with the Australian Democrats, the Government would amend the statutory formula percentages in order to secure the passage of the overall FBT measure.

5.15 The rates that were introduced were:

Total kms travelled during the year	***Statutory rate***
Less than 15,000	0.24
15,000 to 24,999	0.18
25,000 to 40,000	0.10
Over 40,000	0.06

5.16 The statutory formula percentages were increased in 1995-96 to their current rates. The below rates have applied from the FBT year beginning 1 April 1995.

Total kms travelled during the year	*Statutory rate*
Less than 15,000	0.26
15,000 to 24,999	0.20
25,000 to 40,000	0.11
Over 40,000	0.07

5.17 However, the assumption that as distance travelled increases; the business use of the vehicle also increases no longer reflects current vehicle usage data.

5.18 This assumption pre-dates the advent of salary sacrifice arrangements.

5.19 The Australia's Future Tax System Review made the following findings about the current statutory rates:

> 'The statutory formula applies so that the taxable value of a car fringe benefit falls as total kilometres rise. At the margin, this may create an incentive for individuals to travel additional kilometres to reduce the taxable value of their car (particularly at the points at which the statutory fraction falls — 15,000, 25,000 and 40,000 kilometres). This increases pollution and road congestion.'

5.20 The Government announced on 10 May 2011 that it will reform the statutory formula method by replacing the current statutory rates with a single rate of 20 per cent that applies regardless of the distance travelled.

5.21 In the Treasurer's joint Media Release with the Assistant Treasurer and Minister for Financial Services and Superannuation of 10 May 2011, the Deputy Prime Minister and Treasurer, said:

> 'The Gillard Government will change the fringe benefit treatment of cars to remove the unintended incentive for people to drive their vehicle further than they need to, in order to obtain a larger tax concession.'

5.22 A flat statutory rate of 0.20 will better reflect the fair value of the private benefit being provided to the employee and places employees with access to fringe benefits on a more even footing with employees whose remuneration consists entirely of salary or wages.

5.23 The operating cost method for valuing car fringe benefits is not being altered and is available for employers to use.

5.24 Some cars are exempt from FBT (such as where there is only limited private use of a taxi, panel van or ute). There are no changes to these exemptions.

Summary of new law

5.25 A fringe benefit will arise where an employee is provided with a car for private use (this includes home to work travel).

5.26 Car fringe benefits are valued using either the operating cost method or the statutory formula method.

5.27 The statutory formula method is designed to provide employers with a low compliance cost alternative to the operating cost method, eliminating the need to maintain a vehicle log book. The statutory formula method removes the need to explicitly distinguish between the business and private use of a vehicle.

5.28 The new law applies a single statutory rate of 0.20 to car benefits valued under the statutory formula method, regardless of the distance the car travelled during the FBT year.

5.29 The formula for calculating fringe benefits payable on a car fringe benefit using the statutory formula method will now be determined by multiplying the base value of the car by the 0.20 statutory rate, taking into consideration the number of days in the year the car fringe benefits were provided by the employer.

5.30 The statutory formula method will still remain an administratively simple method for calculating the value of car fringe benefits but will now produce a fairer valuation of the private benefit being provided and remove the adverse environmental incentives existing in the current formula.

5.31 The operating cost method will remain unchanged, and is available for employers to use.

5.32 The change will apply to all car fringe benefits after 7:30 pm, AEST on 10 May 2011, except where an employee, employer or their associate has committed to the acquisition of the car that will be the subject of a car benefit (for a specified period of time) prior to 7:30 pm, AEST on 10 May 2011.

5.33 Changes for new contracts will be phased in over four years unless an employer elects to skip the transitional arrangements. However,

an employer cannot force an employee to bear the impact of by-passed transitional arrangements merely to save on compliance costs.

5.34 The general intent of the transitional arrangements is to leave employers/employees who have pre-existing commitments (that is, those who have made financially binding decisions, in relation to a particular car, based on the old rules) under the old arrangements.

5.35 All car benefits will be covered by the new rules unless it can be proved that an agreement was in place prior to 7:30 pm, AEST on 10 May 2011, committing to the transaction. The car benefit does not need to have been delivered by 10 May 2011, but the commitment needs to be financially binding on one or more of the parties.

5.36 Changes made after 7:30 pm, AEST on 10 May 2011 to commitments made prior to 7:30 pm, AEST on 10 May 2011, such as re-financing a car, altering the duration of an existing contract or changing employers, are new commitments and will therefore be subject to the new arrangements.

5.37 If the new rules would begin to apply part way through a year (because of a change in commitment), the changes will commence from the beginning of the next FBT year.

5.38 Existing commitments will be grandfathered.

5.39 Employers and employees who seek to end existing contracts early and immediately enter into new contracts, just to get the benefit of new arrangements, may be caught by the general anti-avoidance provisions.

Comparison of key features of new law and current law

New law	*Current law*
Car fringe benefits are valued using either the operating cost method or the statutory formula method. A single statutory rate of 20 per cent, regardless of kilometres travelled, will apply to car fringe benefits valued under the statutory formula method.	Car fringe benefits are valued using either the operating cost method or the statutory formula method. Under the statutory formula method, the taxable value of the benefit is based on the cost of the car multiplied by the relevant statutory percentage, which depends on the number of kilometres that the car has travelled over the FBT year. The current rates for cars valued under the statutory formula method are: **Kms travelled** — **Rate** Less than 15,000 — 0.26 15,000 to 24,999 — 0.20 25,000 to 40,000 — 0.11 Over 40,000 — 0.07

Detailed explanation of new law

5.40 Fringe benefits are provided to employees (or associates of employees) in place of, or in addition to, salary or wages.

5.41 A fringe benefit usually takes the form of non-money income, such as the use of a company car for private purposes, but can also involve cash, for example where an employee is reimbursed by their employer for private expenses.

5.42 FBT applies to virtually all employers, including government, and is designed to be as inclusive as possible in the coverage of benefits received by employees in respect of their employment. This means that benefits provided by employers to employees in respect of employment are taxed, whether received in cash or otherwise.

5.43 A fringe benefit will arise where an employee is provided with a car for private use (this includes home to work travel).

5.44 Car fringe benefits are valued using either the operating cost method or the statutory formula method.

5.45 Under the operating cost method, the taxable value of the benefit is based on the cost of owning and operating the car, reduced by the portion which relates to the business use of the vehicle. Employers are required to substantiate the business use of the vehicle by maintaining a log book for a specified period.

5.46 The statutory formula method is designed to provide employers with a low compliance cost alternative to the operating cost method, eliminating the need to maintain a vehicle log book. The statutory formula method removes the need to explicitly distinguish between the business and private use of a vehicle.

5.47 The new law provides a flat statutory rate of 0.20 for valuing car fringe benefits under the statutory formula method. This statutory rate applies regardless of the distance the car benefit was driven throughout the course of the year. ***[Schedule 5, items 1 and 4, subsection 9(1) (formula and definitions), paragraphs 9(2)(c) and (d)]***

5.48 The formula for calculating the taxable value of the car fringe benefit under the statutory formula method is ***[Schedule 5, item 1, subsection 9(1) (formula and definition)]***:

$$\left(0.2 \times \text{Base value of the car} \times \frac{\text{Number of days during that year of tax on which the car fringe benefits were provided by the provider}}{\text{Number of days in that year of tax}} \right) - \text{Amount (if any) of the recipient's payment}$$

5.49 The calculation for the base value of the car will be the same as under the previous rules.

Example 5.1: Salary sacrificed car

> Tamara leases a car under a novated lease arrangement with her employer on 1 April 2020. The lease is a three-year lease. The base value of the car is $40,000. During the first FBT year, the car is driven 23,000 kms. The next year, it is driven 40,000 kms, and in the final year the car is driven 37,000 kms. The car is available to Tamara from 1 April 2020, and is available for the whole tax year. The car is solely for private use.

Under the statutory formula method, assuming no employee contribution, the FBT taxable value would be:

for the 2020-21 FBT year: = 0.20 × \$40,000 = \$8,000

for the 2021-22 FBT year: = 0.20 × \$40,000 = \$8,000

for the 2022-23 FBT year: = 0.20 × \$40,000 = \$8,000

Each year, the FBT payable would be \$8,000 × 0.465 (the FBT rate) × 2.0647 (the FBT GST-inclusive gross-up rate) = \$7,681.

Under the statutory formula method, the distance driven by the car throughout the FBT year is irrelevant.

Example 5.2: Salary sacrificed car

Chris leases a car under a novated lease arrangement with his employer on 1 January 2015, on a four-year lease. The base value of the car is \$50,000. The car is used 50 per cent of the time for private use and 50 per cent for work-related use.

During the first FBT year, if Chris makes no employee contribution, the taxable value of the car fringe benefits under the statutory formula method would be:

0.20 × 50,000 × 90/365 = \$2,466

The amount of FBT payable would be
\$2,466 × 0.465 × 2.0647 = \$2,368.

Chris's employer could also require him to keep a log book for 12 weeks during the first FBT year to work out the FBT payable under the operating cost method. The employer could then elect to apply this method to the car fringe benefits.

Application and transitional provisions

5.50 The reforms will apply to all car fringe benefits after 7:30 pm, AEST on 10 May 2011, unless it can be proved that there was a pre-existing commitment in place to provide a car. ***[Schedule 5, item 8]***

5.51 A commitment is considered entered into at the point that there is commitment to the transaction, and it cannot be backed out of. The commitment needs to be financially binding on one or more of the parties.

5.52 Changes made after 7:30 pm, AEST on 10 May 2011 to commitments made prior to 7:30 pm, AEST on 10 May 2011, such as

re-financing a car, altering the duration of an existing contract or changing employers, are new commitments and will therefore be subject to the new arrangements.

5.53 If, however, the amendments do not apply in relation to a car, in relation to an employer, at the start of an FBT year (or from the time the car was first held if that happens after the beginning of the year), and the amendments begin to apply in relation to that car, in relation to that employer during that FBT year, the amendments will instead begin to apply from the start of the next FBT year. ***[Schedule 5, item 8]***

Example 5.3: Transitional arrangements

During April 2011, Constance begins discussions with a salary packaging provider about obtaining a car through a salary sacrifice arrangement. On 2 May 2011, Constance agrees to a particular option with the provider, and the car is ordered. She signs a contract with her employer.

The car is scheduled for delivery on 1 August 2011, at which point she will sign documents with the leasing provider for the provision of the car.

Constance entered into a commitment prior to 7:30 pm, AEST on 10 May 2011, and her contract will be grandfathered.

Example 5.4: Transitional arrangements

Tim is provided with a salary sacrificed car on a lease contract that lasts the sooner of two years or 40,000 kms, commencing 1 January 2010.

On 17 August 2011, as Tim is nearing the 40,000 kms, he gets the contract changed to allow for 50,000 kms. This would be considered a new commitment, and from 1 April 2012, the contract would move to the new arrangements (under the transitional arrangements). (Since the amendments begin to apply part way through an FBT year in relation to a car that was available from 1 April, the new arrangements will apply from 1 April 2012.)

Example 5.5: Transitional arrangements

Travel Co. owns a fleet of cars which are provided to the managers of certain divisions. There is a standing employment agreement with such employees that a car will be provided to them for the duration of their employment with the company.

For each employee, every two years, the car provided is replaced with a new one.

One such car is ordered on 15 May 2011, and the car is replaced on 15 June 2011. If the statutory formula method is used to value the car fringe benefits, the car would fall under the new arrangements.

Example 5.6: Transitional arrangements

Blake entered into a novated lease arrangement with his employer for a car benefit in 2009. The lease expires in September 2011. Blake travelled 32,000 kms in the 2011-12 FBT year. The car is valued under the statutory formula method.

In August, Blake decides to re-finance the same car for another year, and signs a form saying he is extending the lease by 12 months. This would be considered a new arrangement, and Blake will now fall under the new arrangements for valuing car fringe benefits (from the beginning of the next FBT year following the date he signed, 1 April 2012).

Since the amendments begin to apply part way through an FBT year in relation to a car that was available from 1 April, the statutory rate of 0.11 will apply for the entire 2011-12 FBT year with the amendments beginning to apply from 1 April 2012.

From 1 April 2012, a rate of 0.17 will apply.

Example 5.7: Transitional arrangements

Tom entered into a salary sacrifice arrangement for the provision of the use of a car under a novated lease on 1 March 2010. The lease expires 1 March 2013.

On 15 September 2011, Tom decides to have the car windows tinted.

Adding this accessory will not result in a new commitment, and Tom’s contract will remain grandfathered until 1 March 2013.

Example 5.8: Transitional arrangements

Anna works for X Co, and enters into a novated lease arrangement with her employer in January 2010. The lease runs until January 2013. The car fringe benefit is valued under the statutory formula method.

On 12 November 2011, Y Co. officially takes over X Co, and Anna is now an employee of Y Co.

From 12 November 2011, any car benefits provided to Anna will come under the new arrangements.

5.54 Employers and employees who seek to end existing contracts early and immediately enter into new contracts, just to get the benefit of

new arrangements, may be caught by the general anti-avoidance provisions.

5.55 The rates will be phased in over four years according to Table 1.1 ***[Schedule 5, item 9]***:

Table 5.1

Distance travelled during the FBT year (1 April – 31 March)	***Statutory rate (multiplied by the cost of the car to determine the taxable value of a person's car fringe benefit)***				
	Existing contracts	***New contracts entered into after 7:30 pm, AEST on 10 May 2011***			
		From 10 May 2011	***From 1 April 2012***	***From 1 April 2013***	***From 1 April 2014***
0 – 15,000 kms	0.26	**0.20**	0.20	0.20	0.20
15,000 – 25,000 kms	0.20	**0.20**	0.20	0.20	0.20
25,000 – 40,000 kms	0.11	**0.14**	**0.17**	**0.20**	0.20
More than 40,000 kms	0.07	**0.10**	**0.13**	**0.17**	**0.20**

5.56 A contract entered into after 7.30 pm, AEST on 10 May 2011, where the car travels 30,000 kilometres per annum, would use the statutory rate of 0.14 from the start of the contract until 31 March 2012, 0.17 from 1 April 2012 until 31 March 2013, then the statutory rate of 0.20 thereafter.

Example 5.9: Transitional arrangements

James enters into a novated lease arrangement on 1 July 2012 for a car with a base value of $35,000. The lease on the car is for three years, running until 30 June 2015.

In the FBT period from 1 July 2012 to 31 March 2013, James drives 35,000 kms. From 1 April 2013 to 31 March 2014, James drives 42,000 kms in the car. From 1 April 2014 until the end of the lease, James drives 10,500 kms.

From 1 July 2012 until 31 March 2013, the annualised kilometres driven would be $35,000 \times 366 / 275 = 46,582$ kms. As such, the statutory rate applied to the car fringe benefits would be 0.13.

From 1 April 2013 to 31 March 2014, when James drives 42,000 kms, the statutory rate of 0.17 would apply.

From 1 April 2014 until the end of the lease, the annualised kilometres driven would be $10,500 \times 365 / 91 = 42,115$ kms. The statutory rate applying to the lease would be 0.20.

5.57 An employer can choose to skip the transitional arrangements and directly use the flat statutory rate of 0.20 if they choose. The way an employer's return for the relevant year of tax is prepared is sufficient evidence of the making of the choice. ***[Schedule 5, item 9]***

5.58 However, the election to opt-in to the new rules is not effective without the consent of affected employees in cases where, in making an election, an employee would be worse off as a result of their employer making the election. This covers situations where an employee is at a financial disadvantage (without their consent) where their employer opts to skip the transitional arrangements. ***[Schedule 5, item 9]***

5.59 This ensures an employer cannot force an employee to bear the impact of by-passed transitional arrangements merely to save on compliance costs.

Consequential amendments

5.60 There are also some changes being made as a result of the reforms for FBT and car fringe benefits to tidy up and update affected provisions. ***[Schedule 5, items 2, 3, 5, 6 and 7, subparagraphs 9(2)(a)(i) and 9(2)(e)(i), paragraph 9(2)(b), subsections 9(2) and 136(1)]***

5.61 Some provisions that are no longer required under the new rules will be repealed once existing contracts (which are being grandfathered) are no longer in existence. ***[Schedule 5, items 10 to 12, subsections 135K(4), 9(1) (note) and 136(1) (definition of 'annualised number of whole kilometres')]***

Index

Schedule 1: Primary producers' income averaging and farm management deposits

Bill reference	Paragraph number
Item 1, subsection 392-20(1) and item 2, subsection 392-20(2)	1.16
Item 1, subsection 392-20(1) and item 2, subsection 392-20(3)	1.18
Item 1, subsection 392-20(1), item 2, subsection 392-20(4) and item 3, subsections 392-22(1) and (2)	1.23
Item 2, subsection 392-20(5)	1.29
Item 3, subsections 392-22(1) and (3) to (5)	1.24
Item 4, note to section 97A of the ITAA 1936	1.33
Item 5, note to section 202DL of the ITAA 1936	1.34
Item 6, subsection 393-5(1) (note 2)	1.32
Items 7 and 8, subsections 393-25(2) and (3) and item 11, section 393-28)	1.30
Item 9, subsection 393-25(3), item 10, subsections 393-25(5) and (6), item 11, section 393-27	1.26
Items 9 and 10, subsections 393-25(3) and (4)	1.25
Item 12, section 393-35 (note to item 1 in the table)	1.31
Item 13, section 393-27 of the *Income Tax (Transitional Provisions) Act 1997*	1.28
Item 14	1.27

Schedule 2: Interim changes to the taxation of trust income

Bill reference	Paragraph number
Item 1, section 95AAA of the ITAA 1936	2.31
Item 1, section 95AAB of the ITAA 1936	2.218
Item 1, subsections 95AAB(3) and 95AAC(5) of the ITAA 1936	2.221
Item 1, section 95AAC of the ITAA 1936	2.219
Item 2, subsection 95(1) of the ITAA 1936	2.128, 2.192
Items 2 and 4, subsection 95(1) of the ITAA 1936 and item 25, subsection 995-1(1)	2.74

Bill reference	***Paragraph number***
Items 2, 4 and 5, subsection 95(1) of the ITAA 1936 and item 25, subsection 995-1(1)	2.73
Items 3 and 6, subsections 95(1) and 100AB(4) of the ITAA 1936	2.195
Item 6, subsection 100AA(1) of the ITAA 1936	2.178
Item 6, subsections 100AA(1) to (3) of the ITAA 1936	2.173
Item 6, paragraphs 100AA(1)(b) and 100AB(1)(b) of the ITAA 1936	2.172
Item 6, paragraph 100AA(1)(c) of the ITAA 1936	2.179
Item 6, subsection 100AA(2) of the ITAA 1936	2.180
Item 6, subsection 100AA(3) of the ITAA 1936	2.181
Item 6, subsections 100AA(3) and 100AB(2) of the ITAA 1936	2.175
Item 6, subsection 100AA(4) of the ITAA 1936	2.182
Item 6, subsections 100AA(4) and (5) of the ITAA 1936	2.183
Item 6, subsection 100AA(6) of the ITAA 1936	2.185
Item 6, subsections 100AA(7) and 100AB(8) of the ITAA 1936	2.171
Item 6, subsections 100AB(1) and (2) of the ITAA 1936	2.174
Item 6, subsections 100AB(1) and (3) of the ITAA 1936	2.189
Item 6, subsection 100AB(2) of the ITAA 1936	2.190
Item 6, subsection 100AB(3) of the ITAA 1936	2.193, 2.194
Item 6, subsection 100AB(4) of the ITAA 1936	2.196
Item 6, subsection 100AB(5) of the ITAA 1936	2.200
Item 6, subsection 100AB(6) of the ITAA 1936	2.201
Item 6, subsection 100AB(7) of the ITAA 1936	2.203
Item 7, section 102UW of the ITAA 1936	2.28, 2.155
Item 7, sections 102UX and 102UY of the ITAA 1936	2.156
Item 7, subsection 102UY(2) of the ITAA 1936	2.157
Item 7, subsection 102UY(3) of the ITAA 1936	2.159
Item 7, subsection 102UY(4) of the ITAA 1936	2.161
Item 8, section 115-200 and item 10	2.81
Item 9, subsection 115-215(3)	2.80, 2.96, 2.97
Item 9, subsection 115-215(3) and item 11, sections 115-225 and 115-227	2.83
Item 11, section 115-220	2.98
Item 11, sections 115-220 and 115-222	2.82
Item 11, subsection 115-220(1)	2.98
Item 11, paragraph 115-220(1)(b)	2.100
Item 11, section 115-222	2.101

Bill reference	***Paragraph number***
Item 11, subsections 115-222(1) and (2)	2.102
Item 11, subsections 115-222(3) and (4)	2.103
Item 11, subsection 115-225(1)	2.90
Item 11, paragraph 115-225(1)(a)	2.91
Item 11, paragraph 115-225(1)(b)	2.89
Item 11, subsection 115-225(2)	2.93
Item 11, subsection 115-225(3)	2.94
Item 11, section 115-227 and item 26, subsection 995-1(1)	2.85
Item 11, subsection 115-228(1)	2.50, 2.54
Item 11, subsection 115-228(1) and item 24, subsection 207-58(1)	2.47, 2.56
Item 11, paragraph 115-228(1)(c)	2.66
Item 11, paragraph 115-228(1)(c) and item 24, paragraph 207-58(1)(c)	2.62
Item 11, subsection 115-228(3)	2.52
Item 11, section 115-228, item 24, section 207-58 and item 27, subsection 995-1(1)	2.37
Item 11, subsection 115-228(1) and item 24, subsection 207-58(1)	2.38, 2.41
Items 12, 13, 15, 16 and 17, section 115-230	2.107
Item 14, subsection 115-230(2)	2.108
Item 17, paragraph 115-230(4)(a)	2.110
Item 17, paragraph 115-230(4)(b)	2.111
Item 18, subsection 207-35(3)	2.144
Item 18, paragraphs 207-35(3)(d) and 207-35(5)(c)	2.143
Item 18, paragraph 207-35(4)(a)	2.145
Item 18, paragraph 207-35(4)(b)	2.147
Item 18, subsections 207-35(5) and (6)	2.148
Item 18, subsection 207-35(6)	2.149
Item 19, subsection 207-37(1)	2.121
Item 19, subsections 207-37(2) and (3)	2.132
Items 20, 21 and 28 to 50	2.222
Item 22, subsection 207-55(3)	2.124
Item 23, subsection 207-55(4)	2.125
Item 23, paragraph 207-55(4)(a)	2.126
Item 23, subparagraphs 207-55(4)(b)(i) and (ii)	2.127
Item 24, subsection 207-58(1)	2.51, 2.53, 2.134
Item 24, paragraph 207-58(1)(c)	2.67

Bill reference	***Paragraph number***
Item 24, subsection 207-58(2)	2.135
Item 24, section 207-59	2.57, 2.139
Item 51, subitem 51(1)	2.204
Item 51, subitems 51(2) to (4)	2.206
Item 51, subitems 51(5) to (7)	2.208
Item 51, subitem 51(7)	2.209

Schedule 3: National Rental Affordability Scheme

Bill reference	***Paragraph number***
Item 1, subsections 380-10(1) and (2)	3.32
Item 1, subsection 380-10(2)	3.39
Item 1, subsection 380-10(3)	3.42
Item 1, section 380-14	3.46
Item 1, subsection 380-15	3.48
Item 1, subsection 380-15(2)	3.49
Item 1, subsection 380-15(3)	3.50
Item 1, sections 380-5 and 380-20	3.51
Item 2, section 380-32	3.41, 3.72
Item 3	3.81
Item 4, subsections 380-11(1) and (4) and 380-12(1) and (2)	3.54
Item 4, subsections 380-11(2) and 380-16(2)	3.71
Item 4, subsections 380-11(3) and 380-16(3)	3.73
Item 4, section 380-12	3.55
Item 4, subsection 380-12(3)	3.59
Item 4, subsection 380-12(4)	3.58
Item 4, subsection 380-12(5)	3.60
Item 4, subsection 380-12(6)	3.61
Item 4, section 380-13	3.62
Items 5, 12, 13 and 15	3.84
Item 6, section 380-16	3.63
Item 6, subsection 380-16(2)	3.68, 3.69
Item 6, subsection 380-16(5)	3.66
Item 6, subsection 380-16(6)	3.67
Item 6, section 380-17	3.64

Bill reference	*Paragraph number*
Item 6, subsection 380-17(2)	3.65
Item 6, section 380-18	3.70
Item 7	3.82
Item 8	3.83
Item 9, paragraph 118-37(1)(j)	3.78
Item 10, section 380-35	3.76, 3.77
Item 11	3.79
Item 14, subsection 995-1(1)	3.28, 3.30
Item 16, subsection 995-1(1)	3.36
Item 17, subsection 995-1(1)	3.22, 3.27
Item 18, subsection 995-1(1)	3.23
Item 19, subsection 995-1(1)	3.35

Schedule 4: Phasing out the dependent spouse tax offset

Bill reference	*Paragraph number*
Item 1, sub-subparagraph 23AB(7)(a)(ii)(D)	4.34
Item 2, subparagraph 23AB(7)(a)(iii)	4.38
Item 3, subsection 23AB(7A)	4.37
Item 4, paragraphs 79A(2)(a), (d) and (e)	4.40
Item 5, subsection 79A(4)	4.41
Item 6, subsection 79A(4)	4.42
Items 7 and 8, subparagraphs 79B(2)(a)(ii) and (iii)	4.43
Items 9 and 10, subsection 79B(4)	4.44
Item 11, subsection 79B(4A)	4.45
Item 12, subsection 79B(6)	4.46
Item 13, subsection 79B(6)	4.47
Item 14, subsection 159HA(7)	4.48
Item 15, subsection 159J(1C)	4.49
Item 15, subsection 159J(ID)	4.50
Item 15, subsection 159J(1E)	4.51
Item 16, subsection 159J(2) (item 5 in the table)	4.52
Item 17, subsection 159J(3)	4.54
Item 18, subsection 159J(3)	4.55
Item 19, subsection 159J(3A)	4.56

Bill reference	***Paragraph number***
Item 20, subsection 159J(5CA)	4.57
Item 21, subsection 159J(5D)	4.58, 4.59
Item 22, subsection 159J(6)	4.60
Item 23, subsection 159J(6)	4.61
Item 24, subsection 159J(6)	4.62
Item 25, paragraph 159JA(1)(a)	4.64
Item 26, paragraph 159JA(3)(b)	4.65
Item 27, subsection 159L(1)	4.66
Item 28, subsection 159L(1)	4.67
Item 29, paragraph 159L(1)(c)	4.68
Item 30, subsection 159L(3)	4.69
Item 31, subsection 159L(4)	4.70
Item 32, subsection 159P(4)	4.71
Item 33, section 13-1	4.73
Item 34	4.72

Schedule 5: Car fringe benefits

Bill reference	***Paragraph number***
Item 1, subsection 9(1) (formula and definition)	5.48
Items 1 and 4, subsection 9(1) (formula and definitions), paragraphs 9(2)(c) and (d)	5.47
Items 2, 3, 5, 6 and 7, subparagraphs 9(2)(a)(i) and 9(2)(e)(i), paragraph 9(2)(b), subsections 9(2) and 136(1)	5.60
Item 8	5.50, 5.53
Item 9	5.55, 5.57, 5.58
Items 10 to 12, subsections 135K(4), 9(1) (note) and 136(1) (definition of ‘annualised number of whole kilometres’)	5.61