

# THE MOVEMENT OF CAPITAL GAINS TAX PREFERENCES THROUGH TRUSTS AND THE CAUSES OF TAX LAW COMPLEXITY

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On any measure the Australian income tax system is undoubtedly highly complex. Both the personal income tax and the corporate tax have been found to have high and heavily regressive compliance costs. The language in which the law is expressed has arguably been simplified since the TLIP project of the mid 1990s, so that the colourful description of some of it as being ‘expressed with such obscurity that that used to interpreting the utterances of the Delphic oracle might falter in seeking to elicit a sensible meaning from its terms’<sup>1</sup> may no longer be thought to be entirely apt. Nonetheless simplification of the language of tax statutes has done nothing to reduce the amount of operational detail in the statutes. Even after the removal of currently inoperative provisions (constituting approximately one third of the statute) Australia’s tax statutes as such retain the dubious title of the longest in the world. The title for the most extensive set of tax rules in the world remains with the United States where extensive regulations provide necessary operational detail for a relatively general tax statute.

The significance of the sheer volume of operational detail should not be underestimated. Nor should the relative insignificance of the language of the law as such. Quantitative empirical research by Mc Kercher on complexity and compliance by self completers of income tax returns found that factors other than language made the rules difficult to interpret:

“It was therefore concluded that although the instructions and materials (including *TaxPack 2000*) provided by the ATO were a cause of complexity for at least half of the self-completers who participated in the survey, it was the nature of the rules themselves that was the main cause. The rules were difficult to interpret and required voluminous detailed explanatory material that gave rise to ambiguities and uncertainties. Given that it was not technical language that made rules difficult to interpret, it appeared that the difficulties arose from the underlying complexity of tax policy and laws. The rate of change was recognised as a contributing factor, but less important than the difficulties caused by ‘ambiguities/uncertainties’, ‘details’ and ‘forms’.<sup>2</sup>

This finding was also confirmed in Mc Kercher’s qualitative research:

Proposition 2, derived in part from the survey, was that the major cause of complexity was ambiguity, or uncertainty. In order to address uncertainty, considerable detail was provided in *TaxPack*. However, it was clear from

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<sup>1</sup> Per Hill J in *FCT v Cooling* 21 ATR 13 at 30.

<sup>2</sup> M Mc Kerchar, *The Impact of Complexity upon Tax Compliance: A Study of Australian Personal Taxpayers*, Research Study No39, Australian Tax Research Foundation, 2003, at 140.

the case study that subjects were generally not prepared, or unable, to read and understand the level of detail provided. While the survey found that uncertainty was the major cause of complexity for subjects, it was apparent from the case study that providing fuller explanations and details of exceptions and so on, was not an effective way to reduce complexity for taxpayers completing their own return. Subjects wanted certainty, but without unnecessary detail.”<sup>3</sup>

An earlier survey by Long and Swingen of tax agents in a US State found that ‘the rate of change’ followed by ‘ambiguities and uncertainties’, ‘details’ and ‘forms’ were perceived to be the principal causes of complexity.<sup>4</sup>

Such factors appear to contribute to the high degree of complexity involved in the interaction of CGT event E4, the calculation of the non assessable part of a trust distribution in s104-71, the gross up rules for capital gains flowing through trusts in s115-215; the operation of the CGT discount rules in Division 115, the application of the small business concessions in Division 152, and the operation of the rules for applying capital losses and net capital losses against capital gains. Moreover, these rules potentially affect any investor in a unit trust many of whom are retirees who might be thought to have either insufficient background or the economic resources to either comprehend the rules or to pay for the services of experts to interpret them.

This paper begins by reviewing the academic literature concerned with definitional and conceptual issues in tax law complexity. It then notes some possible causes and complexity in the Australian income and fringe benefits tax systems. The paper then examines a series of examples illustrating the interaction of various causes of tax complexity in the operation of CGT event E4. The causes of the complexity in the interaction of the provisions are then highlighted. It is noted that some of these are illustrations of more general causes of complexity in the system whereas others appear to be consequences of some of the choices made by the drafter in drafting the relevant provisions. An attempt is then made at redrafting CGT event E4 and associated sections with a view to reducing the degree of complexity involved in their operation and interaction. The distribution of tax preferred income through trusts is found to be an example of the multiplying effects of the interaction of discrete causes of complexity in the income tax system. The conclusion is reached that, while complexity is inevitable when income and tax preferences flow through an intermediate entity, redrafting of these provisions in a manner which makes the policy intent of provisions and their constituent elements and their relationship to other provisions more apparent could some remove some unnecessary complexity in their interaction.

### ***I: Concepts Of Tax Law Complexity In Academic Literature***

The literature on tax complexity and simplification is extensive. Much of the literature is concerned with measuring complexity and with comparing the extent

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<sup>3</sup> Mc Kercher, *supra* note 2 at 192

<sup>4</sup> S Long and J Swingen, “An Approach to the Measurement of Tax Law Complexity” (1987) *The Journal of the American Taxation Association* 22.

of complexity in different tax systems. This review will focus on definitional and conceptual issues in the tax complexity and simplification literature.

### *Legal Simplicity*

One concept of complexity and simplicity identified in the literature is ‘legal simplicity’. Under this concept the simplicity or complexity of a tax law is determined by the ease or difficulty with which it can be read and understood. Tran Nam suggests that legal simplicity/complexity depend on: (a) the comprehensibility of the language used to express the law; and (b) content of the law. Tran Nam regards the content of the law as encompassing such matters as: the tax base; discretions; uncertainties; exemptions; special concessions; allowable deductions; rebates and multiple tax rates.<sup>5</sup> This description of the content of tax law is largely a classification of its elements based on their functions as mechanisms in determining the taxable quantum in a given instance. For the purposes of determining and measuring the complexity of tax law it may be more useful to distinguish between the policy underpinning the law and the operating rules involved in implementing those policies in the law. Such distinctions can be drawn in each of the categories identified by Tran Nam.

Given the binding nature of precedents and the binding nature of public rulings on the Commissioner an adequate definition of the content of tax law needs to include the interpretations of tax statutes developed by the courts and the Commissioner. If policies underpinning the law are regarded as part of its content then official government statements of intended policy in Explanatory Memoranda and elsewhere need to be regarded as expressions of part of the content of the law.

Although technically not part of the content of the law, in practical terms explanations of the content tax law in *Taxpack* and in practitioner texts are more commonly read than the statute itself.

It is also important to appreciate that other statutes may add to the legal complexity of tax law. The income tax contains numerous tax expenditure programs within it. Frequently accessing these tax expenditures depends on complying with regulatory regimes established in other statutes. Examples include superannuation and the venture capital concessions. The interaction of the tax system with direct expenditure programs (such as social security payments) also can add to its legal complexity as, in practical terms, the effects of changes in a taxpayer’s circumstances need to be considered from both the income tax and social security perspectives. Consideration of these other statutory regimes and their interaction with the income and fringe benefits legislation is beyond the scope of the paper but would merit further research.

Research suggests that merely simplifying the language in which the law is expressed does little to improve the overall legal simplicity of tax law.<sup>6</sup>

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<sup>5</sup> Bihn Tran-Nam, “Tax Reform and Tax Simplification: Some Conceptual Issues and a Preliminary Assessment” (1999) 21 *Sydney Law Review* 500 at 506.

<sup>6</sup> See, for example, R Woellner, S Gaylard, M Mc Kerchar, C Coleman, and J Zetler, “Once More Into The Breach....A Study of Comparative Compliance Costs Under the 1936 and

Complexity in either the expression or the content of the law can operate independently to make the law more or less complex. Complex content will remain complex even where it is expressed in simple language. Conversely simple content can become more complex as the language in which it is expressed becomes less comprehensible.

A change in operating rules may, but will not necessarily, involve a change in the policy behind the law. For example, prior to the introduction of the simplified imputation system, the Australian dividend imputation system contained rules designed to counteract dividend streaming. These included rules dealing with the required franking amount for a dividend. Under the simplified imputation system rules relating to the required franking amount for a dividend were replaced with an arguably more flexible set of rules that nonetheless aim to counteract dividend streaming through the use of the benchmark franking rule and other associated rules. The example highlights the usefulness of the distinction between the fundamental objectives and policies that the law is trying to express and the operational rules that are used to express those fundamental objectives and policies. The example also illustrates that it often may be possible in the process of tax law design to choose between alternative operational rules each of which achieves the fundamental objective. A distinction can also be drawn between fundamental policies and objectives and, often implicit, policies which are consequences of the operational rules chosen to achieve a more fundamental policy objective.

### *Effective Simplicity*

Legal complexity or simplicity should be distinguished from the broader concept of ‘effective simplicity’. Effective simplicity measures the value of resources expended by society in raising a given amount of revenue. Raising a given amount of revenue involves ascertaining how the tax laws apply to a given set of circumstances.<sup>7</sup> As this process potentially involves taxpayers, tax administrators, judicial officers, and legislators, to measure the effective simplicity/complexity of a tax system regard must be had to the costs borne by each of these potential participants.<sup>8</sup> As Tran Nam has noted effective simplicity encompasses legal simplicity but in addition is affected by:

- the number of taxpayers and tax administrators;
- the size distribution of taxpayers;
- business cycle; and
- the general level of tax avoidance and tax evasion in the economy and the government’s commitment to combat these.<sup>9</sup>

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1997 Acts: Progress Article” in C Evans and A Greenbaum, (eds) *Tax Administration: Facing the Challenges of the Future* (1998) 195 at 202 and A Sawyer, “Rewriting tax legislation: Reflections on the New Zealand experience” (2003) 57 *Bulletin for International Fiscal Documentation* 578 at 587. ,

<sup>7</sup> Tran Nam *supra* note 5 at 507

<sup>8</sup> Tran Nam *supra* note 5 at 507

<sup>9</sup> Tran Nam *supra* note 5 at 508.

Similarly, in summarising the concept of complexity as used in the literature to 1993 Cooper noted that:

“a complex system would be one where neither taxpayers nor the revenue authority could identify a taxpayer’s tax (425) liability with an appropriate degree of certainty at reasonable cost, nor could that liability be cheaply and easily satisfied, nor enforced. Those outcomes could be caused by many factors such as choosing inappropriate rules, poor expression of the rules chosen or poor construction of the total system.”<sup>10</sup>

Cooper concluded that in the literature the notion of simplicity contained within it intimations of:

**PREDICTABILITY:** A rule would be simple because the rule chosen and its intended (and actual) scope are easily understood by taxpayers, or by affected taxpayers or perhaps their advisers.

**PROPORTIONALITY:** A rule would not be simple where the degree of complexity of the solution was more than reasonably necessary to achieve the stated policy.

**CONSISTENCY:** The rule chosen deals with similar issues in the same way avoiding distinctions which are arbitrary.

**COMPLIANCE:** The rule chosen would not be simple if it is difficult and excessively costly for taxpayers to comply with.

**ADMINISTRATION:** A rule would be simple if it is an easy rule for the revenue authority to administer.

**CO-ORDINATION:** A rule would be simple if it meshes comfortably with other tax rules and would be complex if the relationships with other rules were obscure.

**EXPRESSION:** The rule chosen is clearly expressed.”<sup>11</sup>

It may be possible to achieve considerable reductions in effective complexity by removing a group of taxpayers or a segment of transactions from the tax net. Such steps, however, would involve more fundamental shifts in policy than the paper is concerned with.

## **II: Causes Of Complexity In The Australian Income Tax System**

There is an extensive literature examining possible causes of complexity in tax systems. Arguably the root cause of the complexity of the Australian tax system is that over time the cumulative development of detailed operational rules has obscured the fundamental policies that those rules should be trying to express.

<sup>10</sup> G S Cooper, “Themes And Issues In Tax Simplification” (1993) 10 *Australian Tax Forum* 417 at 424 to 425.

<sup>11</sup> Cooper, *supra* note 10 at 424.

Several commentators have noted that a major cause of complexity in the tax system is the use of income as a tax base.<sup>12</sup> As Cooper notes the use of income as a tax base typically involves multiple questions and sources for dispute such as: ‘what is income; how much is the income; what kind of income is it; when is it income; whose income is it; which outlays are consumption or savings and which are a cost of income’.<sup>13</sup>

Surrey pointed out that as the income tax is and has to be a mass tax to raise the required levels of revenue. Hence its scope is pervasive. Surrey noted that the modern US income tax had four characteristics: ‘(1) it applies to net income and not gross receipts; (2) it applies on a yearly basis; (3) it applies to the net income of particular taxable units, and the units must be precisely defined; and (4) for individuals it is applied at significantly progressive rates.’<sup>14</sup> The modern Australian income tax shares each of these characteristics with its US counterpart and hence Surrey’s comment on their combined effects is equally applicable to the Australian income tax: ‘Each of these characteristics generates requirements of definition and detail which are bound to produce complexities, especially when the tax is pervasive in coverage.’<sup>15</sup>

Additional causes of complexity in the Australian income and fringe benefits tax systems include.<sup>16</sup>

- (1) ***Obscuring of fundamental policy framework through excessively detailed operational rules due to:***
  - (a) ***the cumulative development of rules; and***
  - (b) ***insufficiently clear and explicit principles governing priorities between rules***

Arguably the root cause of the complexity of the Australian tax system is that over time the cumulative development of detailed operational rules have obscured the fundamental policies that those rules should be trying to express. Overarching all of the other specific causes of complexity discussed below is the relative absence of an obvious, coherent and consistently implemented framework of fundamental policy objectives. The fundamental design objectives of the tax law too often retreat into the background and are obscured by detailed operative provisions which are often poorly co-ordinated. While many tax laws develop these features over time Australian tax laws display them to an extreme extent. The reasons for this characteristic appear to be largely historical.

<sup>12</sup> See, for example, Cooper, *supra* note 10 at 432 to 434 and Stanley S Surrey, “Complexity and the Internal Revenue Code: The Problem Of The Management Of Tax Detail” (1969) 34 *Law And Contemporary Problems* 673 at 674.

<sup>13</sup> GS Cooper, *supra* note 10 at 432.

<sup>14</sup> Surrey, *supra* note 12 at 675.

<sup>15</sup> Surrey, *supra* note 12 at 675.

<sup>16</sup> The following analysis is based on C J Taylor, *Beyond 4100: A report on measures to combat rising compliance costs through reducing tax law complexity*, Taxation Institute of Australia, 2006.

As is widely recognised, cases interpreting Australian income tax legislation adopted a concept of income that had been used in interpreting English income tax statutes. Under this concept numerous receipts (such as most notably capital gains) which would be income under the economist's gain notion of income were not so regarded. Over the years this ordinary concept of income has been supplemented by numerous rules which generally bring Australian income and fringe benefits taxes closer taxing all realised gains. In many instances legislative rules broadening the income tax base were developed in response to specific tax planning strategies that exploited departures from horizontal equity in the tax system. In most instances (with some notable exceptions) new specific rules were added to but did not replace existing general rules and case law.

This cumulative development of rules has meant that in many instances more than one tax rule could apply to a particular transaction and that frequently the priorities between these potentially conflicting rules are neither clear nor explicit. Rather the approach has been to require the reader of the legislation to work through each of the technical triggers for each of the potentially applicable rules and, in instances where the technical requirements of more than one rule are met, apply an anti overlap rule.

The overall policy of the law in these situations often has to be inferred from the end result of this technical analysis. Here processes involved in the operation of the law are commonly complex and may involve considerable cross referencing between trigger provisions and definitions found in different parts of the legislation or even in different legislation. In these situations the policy underpinning the law will also be complex in the sense that it will be at best implicit and at worst unclear and possibly internally inconsistent. The cumulative development of excessively detailed operational rules eventually obscures the fundamental principles that the law is trying to express.

Cooper has noted a further consequence of the cumulative development of rules. When earlier anti avoidance provisions are not repealed or substantially modified when new provisions are introduced, the earlier provision can be transmogrified into a tax shelter.<sup>17</sup>

**(2) *Use Of Complex Anti Overlap Rules Reconciling Different Potentially Operative Provisions***

Another consequence of the cumulative development of rules is the existence of complex anti overlap provisions reconciling different potentially operative provisions. Examples include:

CGT and other inclusions	ITAA97 s118-20
CGT and trading stock	ITAA97 s118-25
CGT and capital allowances	ITAA97 s188-24
Capital losses and revenue losses	ITAA97 s110-55(9)

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<sup>17</sup> Cooper, *supra* note 10 at 438 to 439.

FBT and assessable income	ITAA36 s23L; s26(e)(iv) & (v) FBTAA s136 definitions of 'fringe benefit' and 'salary or wages'
CFC and FIF	ITAA36 s494
Capital allowances and Div 43	ITAA97 s40-45(2) and s43-70(2)(e)
CGT and Buy Backs	ITAA36 s159GZZZQ(3)
Foreign exchange gains/losses	ITAA97 s775-15 and s775-30

The use of complex anti overlap provisions can add to the complexity of tax laws in at three ways. First, for example in the case of the CFC and FIF rules, the effect of the anti overlap rule may be unclear leading to the development of an unclear boundary between two sets of rules. Unclear boundaries are likely to add to the compliance costs of taxpayers undertaking transactions as they are likely to increase the need for and cost of specialist tax advice.

Secondly, for example in the case of the general CGT anti-overlap rule in s118-20, the anti overlap rule might not come into operation until the last step in the computation of amounts to be taxed. Particularly where cost rules differ between different parts of the tax legislation this can mean that a taxpayer will need to calculate two potentially taxable amounts and then apply an anti overlap provision. In these situations some advisors may work on the simplifying assumption in the case of CGT that if an ordinary income provision applies then CGT is irrelevant. Such an approach risks inaccuracy in computation of the actual tax liability of the taxpayer with consequent adverse effects on subsequent administrative and compliance costs.

Note that the second problem would not have arisen in relation to CGT if Option Two/Tax Value Method proposed by the Review of Business Taxation had proceeded. Under that approach CGT treatment would have been a concessional carve out for particular types of identified assets. In part, therefore, the existence of this problem in relation to CGT can be seen as an operational consequence of a fundamental policy choice of retaining the ordinary concept of income but supplementing it by specific provisions like CGT. The complexities involved in the operation of the general CGT anti double counting provision can thus be seen as being a consequence of the fundamental policy choice made in designing Australia's CGT regime and broader tax reform agenda.

Another broad policy choice also appears to be behind the type of general anti overlap rule used in Australia's CGT. This is a policy of applying capital gains tax to receipts that were not within the ordinary concept of income not merely to capital gains. If the policy had been to only tax capital gains it would have been possible for overlap between ordinary income and capital gains to have been avoided by expressly confining capital gains tax to gains on capital account. An example of this approach can be found in the Canadian capital gains legislation. This method of preventing overlap would have nonetheless involved some complexity as it would have drawn on the extensive and somewhat difficult case law

distinguishing between ordinary income and capital receipts. These problems could be reduced by adopting the United States approach of defining a capital asset in the statute.

A third problem with some Australian anti overlap rules is the complexity involved when the anti overlap rule turns on a distinction drawn in an extensive body of case law. This problem can be seen in the anti overlap rule between ITAA97 Division 40 and ITAA97 Division 43 which ultimately turns on whether or not the item of depreciable property is 'plant' in the sense discussed in an extensive body of case law.

### (3) *Rules Rendered Unnecessary By Subsequent Developments*

Tax rules are developed by enacting new legislation and by the interpretation of existing legislation by the courts. Both forms of development can render existing rules redundant.

Judicially developed rules are always a response to a specific fact situation. While judicially developed rules should be, and usually are, consistent with what judges perceive to be the policy behind a particular provision, it is unreasonable to expect the development of judicial rules on a case by case basis to eliminate overlaps in subject matter between particular statutory regimes or to develop or even co-ordinate a framework of relationships between specific statutory regimes. Judicial respect for the sovereignty of Parliament means that judicially developed rules can only interpret rather than change rules developed by Parliament. Judges should try to interpret rules so that the system as a whole has a rational operation but they cannot impose rationality where it is lacking due to an uncoordinated development of statutory rules over time.

Economic developments, for example in the way that business is organised or financed or communicates, can call for the application of judicial and statutory rules to changed circumstances. For the reasons stated above judicial rules developed in response to such changed circumstances might not result in a rational overall system of rules. Statutory rules and rulings developed in response to changed economic circumstances can often represent a response to the specific circumstance in question. When this happens new rules enacted will often be in addition to rather than in substitution for existing rules.

The development of more than one set of functionally similar rules can add to the complexity of the tax system in several ways. Firstly, it adds to the sheer bulk of the statutory rules. As discussed above research by Mc Kerchar and by Long and Swingen has found that the sheer number and length of rules contributes to the complexity of income tax systems. Second, the enactment of functionally equivalent rules at different times often means that technical differences exist between sets of rules. Often those technical differences can be the product of extraneous factors, such as changes in drafting styles, rather than being features that serve a specific and necessary function when dealing with the subject matter in question. The existence of unnecessary differences between functionally equivalent rules is likely to distort economic behaviour

and to result in inefficient tax motivated transactions. Thirdly, a multiplicity of rules and unnecessary differences between them obscures the principles the rules are trying to express and the fundamental principles of the tax system overall.

**(4) *Situations Where The Literal Meaning Of A Rule Is Never Or Rarely Enforced***

Administrative practice may sometimes be to not apply a provision according to its literal tenor. At least three distinct reasons for this administrative practice may be identified. First, in many circumstances it may be difficult or impossible as a practical matter to give effect to the provision in its literal meaning. An example would be ITAA36 ss44(1)(b). Secondly, administrative authorities do not believe that the literal meaning of a provision reflects the intention of Parliament in enacting the provision. An example would be ITAA36 s99B. Thirdly, administrative authorities do not believe that the literal meaning of a provision produces an appropriate, fair or practical policy result. An example would be the treatment of capital gains in discretionary trusts where the capital and income beneficiaries differ.

**(5) *Duplication Of Interpretative/Computational Rules***

Another consequence of the cumulative development of Australian income and fringe benefits tax rules is the duplication of interpretative rules in different parts of the tax legislation. Some examples include:

<i>Type Of Rule</i>	<i>Provisions Containing Rules Of This Type</i>
Asset rules	<p>Examples include:</p> <ul style="list-style-type: none"> <li>CGT provisions</li> <li>Capital allowance provisions</li> <li>Securitised asset – for thin capitalisation rules s820-942(3)</li> <li>Many provisions use the term ‘asset’ in an undefined or an incompletely defined sense (eg s715-145; s995-1 definition of equity capital of an entity; s995-1 definition of market value of an asset; s995-1 definition of transfer value of an asset; s320-170 assets of a virtual PST)</li> </ul>
Cost rules	<p>Examples include:</p> <ul style="list-style-type: none"> <li>CGT provisions</li> <li>Capital allowance provisions</li> <li>Capital works allowance provisions</li> <li>Trading stock provisions</li> </ul>
Proceeds rules	<p>Examples include:</p> <ul style="list-style-type: none"> <li>CGT provisions</li> <li>Capital allowance provisions</li> </ul>

Capital works allowance provisions  
Trading stock provisions

Realisation events	Examples include: CGT provisions Capital allowance provisions
Relationship rules	CFC provisions Company loss provisions FBT provisions Thin Capitalisation rules

In some instances there may be sound policy reasons for interpretative/computational rules varying between different parts of the tax legislation. In many cases, however, there do not appear to be expressed or obvious policy for differences between interpretative/computational provisions in different parts of the tax legislation. Having distinct definitions of equivalent terms in different parts of the tax legislation is likely to mean that a reader will need to check the definition of a term more frequently than would be the case if the practice were to only have separate interpretative/computational rules where there was a sound policy reason for the use of separate rules. Thus the use of distinct definitions of equivalent terms in different parts of the tax legislation is likely to increase the compliance (and possibly the administrative) costs of the tax system. Hence it would be desirable for a more comprehensive set of common interpretative rules to be developed which could be varied where necessary in particular cases.

**(6) *Rules For Exceptional Circumstances Assuming A Disproportionate Significance***

As rules have developed cumulatively exceptional or problematic circumstances are identified from time to time. Where the exceptional or problematic circumstance has not been foreseen when the provisions dealing with particular transactions were originally enacted they are commonly dealt with by specific exceptions. This technique can lead to the problems identified under (a) above. Where the exceptional or problematic circumstances are identified when the original provisions are enacted the drafter will try to take the exceptional or problematic circumstances into account in designing the original provisions. In some instances this process may affect the whole structure of and terminology used in particular provisions. Where exceptional or problematic circumstances influence the overall structure and terminology of provisions it is arguable that the influence of those circumstances on the overall rules is disproportionate to their significance.

This disproportionate influence can contribute to the complexity of tax rules in several ways. First, there can be a tendency to develop terminology designed to accommodate both the usual and the exceptional circumstances. This can produce terminology which is inconsistent with commonly used commercial terminology. It also means that consideration of usual situations is complicated by a terminology designed to encompass an exceptional or problematic situation which may rarely arise. A clear example of this tendency can be seen in the capital allowance provisions.

Secondly, allowing exceptional or problematic circumstances to influence overall structure disproportionately can produce a tendency towards a tabular drafting style where rules dealing with different categories of circumstance are set out in a series of tables. While perhaps promoting readability this drafting style can have the effect of obscuring the recognition of key principles. Under this approach the detail of the provisions become more readable at the expense of an appreciation of the overall effect and architecture of the provisions. The clearest example of this tendency can be seen in the capital gains tax provisions.

(7) *Poor targeting of rules*

Rules that are only relevant to entities with some characteristics or in some circumstances are sometimes applied to a broader class of entities and circumstances. Where the relevant circumstance would otherwise give rise to a tax planning strategy then, typically, complex integrity measures are introduced to deal with those circumstances. Complex rules can also develop to deal with practical issues that arise for some but not all entities in the class to which the rules apply. In both of these cases some entities have to work within a set of rules that is more complex than is necessary to deal with their particular circumstances. Both instances of this cause of complexity can be seen in the dividend imputation system. The complex rules on maintaining a franking account, franking a dividend, anti dividend streaming and anti capital benefit streaming are products of a combination both practical and integrity concerns. Practical concerns mean that a shareholder allocation system of corporate-shareholder taxation (along the lines of the US sub-chapter S corporation) is not a viable option in widely held companies with more than one class of shareholder. Integrity concerns (flowing from a policy of not giving credit for payments of foreign tax in the dividend imputation system, a policy of not wanting to impose a compensatory tax, and a policy of not giving imputation credits to non residents) give rise to the franking account and franking rules, the anti dividend streaming and anti franking credit trading rules. Even though a small closely held company may have only one class of shareholders, no foreign source income, and only resident shareholders it still has to comply with the complex rules of the dividend imputation system even though it has none of the characteristics that led to the development of those rules.

In these cases it would appear to be desirable to develop an alternative simpler set of rules applicable to entities having defined characteristics and

allowing those entities to opt for the simpler treatment. A flawed example of this approach can be seen in the simplified tax system rules.

**(8) *Rules affecting the derivation of income and gains and the incurring of expenses and losses through entities where parts of the rules operate at different levels of the entity***

The processes involved in determining tax liability in a given situation can become complex when different parts of the legislation operate at different levels.<sup>18</sup> A simple example can be seen in the taxation of partnerships where the trading stock, depreciation and ordinary income provisions operate at the partnership level while the CGT provisions operate at the individual partner level. Particularly complex processes can be involved where an amount is included at one level, for example in calculating the net income of a partnership or trust, and then an adjustment is made at another level, for example an adjustment at the partner or beneficiary level for the purpose of correctly applying provisions such as the CGT provisions or the dividend imputation system. In some instances in the existing legislation the processes involved appear to have been complicated unnecessarily by the addition of amounts at one level and their subtraction at another level. An example can be seen in the provisions dealing with franking credits flowing through partnerships and trusts.<sup>19</sup>

**(9) *Use Of Specific Anti Avoidance Provisions And The General Anti Avoidance Provision Concurrently***

ITAA36 and ITAA97 contain numerous specific anti avoidance provisions. In most instances a transaction which satisfies the requirements for exclusion from a specific anti avoidance provision is not thereby relieved from the potential operation of the general anti avoidance provision in ITAA36 Part IVA. This raises questions about the true function of these specific anti avoidance provisions. One virtue of specific anti avoidance provisions can be that they provide greater certainty than does a general anti avoidance provisions. Where a specific anti avoidance provision is nonetheless subject to the general anti avoidance provision no greater certainty is provided as the possible application of the general anti avoidance provision is unaffected. The principal functions of specific anti avoidance provisions in these instances appear to be as prophylactics against tax planning and a consequent reduction in administrative costs. In these circumstances it is likely that any reduction in administrative costs would be offset by increases in compliance costs.

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<sup>18</sup> A similar point was made by Stanley S Surrey, *supra* note 12 at 685 noting the complexities involved when tax preferences at one level must be traced through to another level.

<sup>19</sup> See C J Taylor, "Problems With Franking Credits Flowing Through Partnerships And Trusts In Australia: The 2004 Amendments And A Simpler Alternative" (2005) 34 *Australian Tax Review* 154

**(10) *Use Of Detailed Computational Steps (Method Statements) Without Indicating What The Overall Purpose And Effect Of The Computational Steps Is***

The Method Statement is a popular drafting technique within ITAA97. It can have the advantage of enabling the production of a precise numerical amount which can be taken into account for tax purposes in particular circumstances. Method statements can sometimes be extremely lengthy and complex and working through them can involve cross referencing to definitions and other operative rules and method statements. This in itself is likely to increase the legal complexity of the particular rule expressed in the method statement. More importantly the price that can sometimes be paid for achieving precision and detail through the use of a method statement is a loss of appreciation of the overall effect of a rule. The forest is lost in the trees. The reader has to work through the method statement and not only come up with a numerical answer but then has to draw conclusions about what the overall effect of the method statement has been. In some instances the reader may be able to conclude that, because of particular steps in the method statement, different tax effects would have been obtained if a particular transaction had been structured differently. In some instances such analysis may produce results that, while being consistent with the literal language of the method statement, are probably at odds with its intended effect. Thus, benefits, in terms of both reduced complexity and increased integrity, may be likely to be produced if all method statements were accompanied by a statement of the overall effect and intention of the statement.

**(11) *Inclusion Of Material That Is Irrelevant To Some Taxpayers In Operative Provisions And Computational Steps***

The basis on which rules are grouped together and organised in legislation can mean that provisions which are only relevant to some taxpayers are included in operative rules and method statements. The most likely result of such grouping is that taxpayers and their advisors need to read through or at least consider whether to read, sometimes large, amounts of irrelevant material. This can only add to the time taken to comply with the legislation and is likely to increase the uncertainty of the application of the legislation. The problem appears to be almost endemic in the ITAA.

Vann notes that the basic choices in tax design involve grouping according to mechanical function (so that all income inclusions are grouped together, all deductions are grouped together, all credits are grouped together and so on) and grouping according to subject matter (so, for example, all provisions dealing with foreign source income would be grouped together).<sup>20</sup> Within a grouping, however, further sub groupings are possible and these in turn may be on the basis of either mechanical

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<sup>20</sup>

R J Vann, "Improving Tax Law Improvement: An International Perspective" (1995) 12 *Australian Tax Forum* 193 at 217.

function or subject matter. To the extent that the grouping at the macro level is according to mechanical function the likelihood of the rules containing provisions that are relevant to only some taxpayers who read them increases.

### **(12) Complex Policy Choices**

Complex policy choices can mean that some complexity in the operative rules implementing the policy chosen is virtually inevitable. Most often complexity will arise where the tax treatment is given to taxpayers or transactions which, while similar in a more general sense, differ according to whether they have particular characteristics.

A fundamental policy choice which produces much complexity is the decision to tax capital gains on a realisation basis. The use of a realisation basis combined with long holding periods of capital assets, the effect of inflation, and the progressive rate scale for individuals, combine to induce legislators to provide concessional tax treatment for capital gains. Hence, in Australia, we initially allowed the cost base of assets to be indexed to inflation in calculating capital gains and since 1999 we have discounted capital gains derived by individuals, trusts and complying superannuation funds. Similarly the use of a realisation basis for taxing capital gains is generally thought to entail the need to develop rules for quarantining capital losses given that a taxpayer can choose the time at which a gain or loss is realised. The need for quarantining rules is exacerbated by the concessional treatment given to capital gains reducing as it does the value of a capital loss.

A further manifestation of this cause of complexity arises where a different tax treatment is given to economically equivalent transactions according to whether they have a particular legal form. Tax preferences, such as the small business CGT concessions, can be seen as another variant on this cause of complexity.

Policy becomes particularly complex when the policy choice is made that the treatment of tax preferences as they pass through intermediate entities should differ according to the type of preference and according to the type of entity.<sup>21</sup> Section 3 of this paper contains an examination of this cause of complexity in the treatment of distributions of tax preferred income by trusts.

In some instances complex policy choices may be a consequence of the cumulative development of rules noted in (a) above. For example, Cooper has argued that, assuming that fringe benefits are to be taxable to the employer, it would have been simpler to tax all cash benefits to the employee and to subject all non cash benefits to FBT. Instead, arguably due to the cumulative development of rules, we continue to tax some non cash benefits under ITAA36 s26 (e) and in addition include non cash

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<sup>21</sup> A point made by Surrey, *supra* note 12 at 685.

business benefits in the assessable income of the recipient via the combined operation of ITAA36 s21A and ITAA97 s6-5.<sup>22</sup>

Subsequent developments may also mean that an initial policy choice that was thought to have lower operating costs over time proves to have higher operating costs than alternative policies. Again, the gradual development of the FBT rules as problems in their operation emerged is an example. The introduction of the obligation to disclose reportable fringe benefits amounts on group certificates arguably negates the major operating cost savings that initially formed a major justification for levying FBT on employers.

### ***III: Distributions Of Tax Preferred Income Through Trusts***

A distribution of tax preferred income through trusts involves a consideration of CGT event E4, the calculation of the non assessable part of a trust distribution in s104-71, the gross up rules for capital gains flowing through trusts in s115-215; the operation of the CGT discount rules in Division 115, the application of the small business concessions in Division 152, and the operation of the rules for applying capital losses and net capital losses against capital gains. The following examples illustrate some of the complexity that can typically be involved in the interaction of these provisions. Following the examples some observations are made on why the interaction of these provisions is so complex. An attempt is then made at redrafting the provisions. This is followed by an explanation of the redraft which points out the respects in which it should reduce the legal and effective complexity of the interaction of these provisions.

#### **Example 1**

*Alpha, Beta, Gamma Pty Ltd each and Delta Pty Ltd each own 1000 units in the ABGD Unit Trust. Each of Alpha, Beta and Gamma Pty Ltd are sui juris Australian residents and the units are post CGT assets to each of them. Each unit was acquired on 1 January 2004 at a cost of \$1. In the year ending 30 June 2005 the ABG Unit Trust has a trust income of \$100,000 and a net income for tax purposes of \$50,000. The excess of trust income over net income was due to the s102-5(1) general 50% discount applying to the calculation of the capital gain taken into account in the trustee's s95 calculation of the net income of the trust estate. On 30 June 2005 the ABGD Unit Trust makes a distribution of \$1 per unit to each of its unit holders. The trustee advises the unit holders that 50c of each dollar distributed represents a net capital gain taken into account in the trust's s95 calculation and 50c represents a distribution of the s102-5(1) 50% discount component.*

*For the year ending 30 June 2005 Alpha had no capital losses from other activities, Beta had a capital loss of \$600 from the sale of shares in listed companies and a non discounted capital gain of \$400 from another share sale, Gamma Pty Ltd had no capital losses from other activities, while Delta Pty Ltd had a capital loss of \$800 from a sale of shares in other listed companies.*

<sup>22</sup>

Cooper *supra* note 10 at 434 to 435.

*The effects of the distribution of \$1000 to each of the unit holders will be as follows:*

***Alpha***

*Assessment of distribution of net capital gain component:*

Share of net capital gain included in assessable income via s97(1)	\$500
Extra capital gain included in assessable income via s115-215(3)(b)	\$1000
Apply 50% discount to s115-215(3)(b) inclusion	\$500
Net s115-215(3)(b) inclusion	\$500
Assessable income	\$1000
Deduction under s115-215(6) of the part of the s97(1) inclusion of the trust estate's net capital gain mentioned in s102-5(1)	\$500
Taxable income from distribution	\$500

*CGT Effects Of Non Assessable Component In Distribution*

Calculation of non assessable component for purposes of CGT event E4 s104-70.

Under s104-70(1)(b) the 'non assessable part' will be the part of the distribution that is not included in your assessable income. In Alpha's case this will be \$500 being the 50% discount component in the distribution. Subsection 104-70(1) goes on to state that in working out what part of the payment is included in your assessable income "disregard your share of the trust's net income that is subject to the rules in s115-215(3)". Unfortunately the phrase 'your share of the trust's net income' is not used in s115-215(3) itself. Subsection 115-215(1) does state that the purpose of s115-215 is to "ensure that appropriate amounts of the trust estate's net income attributable to the trust estate's capital gains are treated as a beneficiary's capital gains". It is not clear from the terms of s104-70(1) whether this statement refers to the share of net income that is included in the beneficiary's assessable income via s97(1) itself or whether it refers to the additional capital gain included via s115-215(3). The former reading, however, appears to be inconsistent with the Example that follows s104-71. Hence the latter reading is to be preferred even though it is difficult to see how the extra capital gains that the beneficiary is treated as having under s115-215(3) can be said to be the beneficiary's 'share of the trust's net income that is subject to the rules in subsection 115-215(3)." If this was the intent of Parliament then it would have been more clearly expressed if s104-70(1) had

referred to “any extra capital gains that you are regarded as having because of the operation of s115-215(3)”. .

In Alpha’s case an adjustment to the non assessable part is then made via Item 1 in the Table in s104-71(4). This will mean that so much of the distribution as reflects the 50% general CGT discount ie \$500 at the trust level will be excluded from the non assessable amount.

Hence in Alpha’s case the non assessable amount of the distribution will be zero. Hence no capital gain will be made by Alpha under s104-70(4) and there will be no reduction in the cost base of Alpha’s units under s104-70(6).

### ***Beta***

*Assessment of distribution of net capital gain component:*

Share of net capital gain included in assessable income via s97(1)	\$500
Extra capital gain included in assessable income via s115-215(3)(b)	\$1000
Capital gain from other share sale	\$400
Capital gain from other share sale after offsetting capital loss of (\$600) against it	\$0
Extra capital gain included via s115-215(3)(b) following offset of balance (\$200) of capital loss	\$800
Apply 50% discount to s115-215(3)(b) inclusion after offsetting of balance of capital loss	\$400
Net capital gain	\$400
Assessable income	\$900
Deduction under s115-215(6) of the part of the s97(1) inclusion of the trust estate’s net capital gain mentioned in s102-5(1)	\$500
Taxable income	\$400

*CGT Effects Of Non Assessable Component In Distribution*

In these circumstances the CGT effects for Beta of the non assessable component in the distribution will be the same as for Alpha.

***Gamma Pty Ltd's Position***

*Assessment of distribution of net capital gain component:*

Share of net capital gain included in assessable income via s97(1)	\$500
Extra capital gain included in assessable income via s115-215(3)(b)	\$1000
Net capital gain	\$1000
Assessable income	\$1500
Deduction under s115-215(6) of the part of the s97(1) inclusion of the trust estate's net capital gain mentioned in s102-5(1)	\$500
Taxable income from distribution	\$1000

*CGT Effects Of Non Assessable Component In Distribution CGT Effects Of Non Assessable Component In Distribution*

In these circumstances the CGT effects for Gamma Pty Ltd of the non assessable component in the distribution will be the same as for Alpha as discussed above.

***Delta Pty Ltd's Position***

*Assessment Of Distribution Of Net Capital Gains Component*

Share of net capital gain included in assessable income via s97(1)	\$500
Extra capital gain included in assessable income via s115-215(3)(b)	\$1000
Extra capital gain included via s115-215(3)(b) following offset of capital loss (\$800) from other share sale.	\$200
Assessable income	\$700

Deduction under s115-215(6) of the part of the s97(1) inclusion of the trust estate's net capital gain mentioned in s102-5(1)	\$500
Taxable income	\$200

*CGT Effects Of Non Assessable Component In Distribution CGT Effects Of Non Assessable Component In Distribution*

In these circumstances the CGT effects for Delta Pty Ltd of the non assessable component in the distribution will be the same as for Alpha as discussed above.

**Example 1.1**

*Assume the facts in Example 1 with the variation that the trust has a revenue loss of \$10,000. This will mean that it has a trust income of \$90,000 and a net income of \$40,000 (given that the revenue loss will be offset only after the 50% discount has been applied at the trust level). Hence the trustee make a distribution of \$900 to each unit holder and would advise the unit holders that the distribution consisted of general 50% discount of \$500 and a net capital gain of \$400.*

The effects of the distribution of \$900 to each unit holder will be as follows:

***Alpha***

*Assessment of distribution of net capital gain component:*

Share of net capital gain included in assessable income via s97(1)	\$400
Extra capital gain included in assessable income via s115-215(3)(b)	\$800
Apply 50% discount to s115-215(3)(b) inclusion	\$400
Net s115-215(3)(b) inclusion	\$400
Assessable income	\$800
Deduction under s115-215(6) of the part of the s97(1) inclusion of the trust estate's net capital gain mentioned in s102-5(1)	\$400
Taxable income from distribution	\$400

*CGT Effects Of Non Assessable Component In Distribution*

Calculation of non assessable component for purposes of CGT event E4 s104-70.

Under s104-70(1)(b) the 'non assessable part' will be the part of the distribution that is not included in your assessable income. In Alpha's case this will be \$500 which represents the 50% discount.

In Alpha's case an adjustment to the non assessable part is then made via Item 1 in the Table in s104-71(4). This will mean that so much of the distribution as reflects the 50% general CGT discount at the trust level ie \$500 will be excluded from the non assessable amount.

Hence in Alpha's case in this example the non assessable part will be zero.

**Beta**

*Assessment of distribution of net capital gain component:*

Share of net capital gain included in assessable income via s97(1)	\$400
Extra capital gain included in assessable income via s115-215(3)(b)	\$800
Capital gain from other share sale	\$400
Capital gain from other share sale after offsetting capital loss of (\$600) against it	\$0
Extra capital gain included via s115-215(3)(b) following offset of balance (\$200) of capital loss	\$600
Apply 50% discount to s115-215(3)(b) inclusion after offsetting of balance of capital loss	\$300
Net capital gain	\$300
Assessable income	\$700
Deduction under s115-215(6) of the part of the s97(1) inclusion of the trust estate's net capital gain mentioned in s102-5(1)	\$400
Taxable income	\$300

*CGT Effects Of Non Assessable Component In Distribution*

In these circumstances the CGT effects for Beta of the non assessable component in the distribution will be the same as for Alpha.

***Gamma Pty Ltd's Position***

*Assessment of distribution of net capital gain component:*

Share of net capital gain included in assessable income via s97(1)	\$400
Extra capital gain included in assessable income via s115-215(3)(b)	\$800
Net capital gain	\$800
Assessable income	\$1200
Deduction under s115-215(6) of the part of the s97(1) inclusion of the trust estate's net capital gain mentioned in s102-5(1)	\$400
Taxable income from distribution	\$800

*CGT Effects Of Non Assessable Component In Distribution CGT Effects Of Non Assessable Component In Distribution*

In these circumstances the CGT effects for Gamma Pty Ltd of the non assessable component in the distribution will be the same as for Alpha as discussed above.

***Delta Pty Ltd's Position***

*Assessment Of Distribution Of Net Capital Gains Component*

Share of net capital gain included in assessable income via s97(1)	\$400
Extra capital gain included in assessable income via s115-215(3)(b)	\$800
Extra capital gain included via s115-215(3)(b) following offset of capital loss ( \$800) from other share sale.	\$0
Assessable income	\$400
Deduction under s115-215(6) of the part	\$400

of the s97(1) inclusion of the trust estate's net capital gain mentioned in s102-5(1)	
Taxable income	\$0

*CGT Effects Of Non Assessable Component In Distribution CGT Effects Of Non Assessable Component In Distribution*

In these circumstances the CGT effects for Delta Pty Ltd of the non assessable component in the distribution will be the same as for Alpha as discussed above.

**Example 1.2**

*Assume the facts in Example 1 with the variation that the trust incurs a revenue loss of \$80,000. This will mean that it has a trust loss of \$30,000 for tax purposes. Hence the trustee make a distribution of \$200 to each unit holder and would advise the unit holders that the distribution consisted of general 50% discount of \$200.*

The effects of the distribution of \$200 to each of the unit holders will be as follows:

***Alpha***

*Assessable income aspects of distribution*

No s97(1) inclusion and no s115-215 inclusion as there has been no ITAA 1936 Part III Div 6 inclusion. It is assumed that, consistently with the Commissioner's practice, s99B will not be applied in these circumstances.

*CGT Effects Of Non Assessable Component In Distribution*

Calculation of non assessable component for purposes of CGT event E4 s104-70.

Under s104-70(1)(b) the 'non assessable part' will be the part of the distribution that is not included in your assessable income. In Alpha's case this will be \$200 which represents the 50% discount.

In Alpha's case an adjustment to the non assessable part is then made via Item 1 in the Table in s104-71(4). This will mean that so much of the distribution as reflects the 50% general CGT discount at the trust level ie \$200 will be excluded from the non assessable amount.

Hence in Alpha's case in this example the non assessable part will be zero. The end result is somewhat anomalous in that Alpha receives \$200 entirely tax free and with no effect on the cost base of Alpha's units.

***Beta***

*Assessable income aspects of distribution*

Capital gain from other share sale	\$400
Net capital loss after offsetting capital loss of (\$600) against capital gain from other share sale	(\$200)

*CGT Effects Of Non Assessable Component In Distribution*

In these circumstances the CGT effects for Beta of the non assessable component in the distribution will be the same as for Alpha. The end result is that Beta will incur a net capital loss of \$200 and will receive a distribution of \$200 entirely tax free and with no effect on the cost base of Beta's units.

***Gamma Pty Ltd***

Gamma Pty Ltd's position will be the same as Alpha's in these circumstances.

***Delta Pty Ltd****Assessable income aspects of distribution*

Net capital loss      \$800

*CGT Effects Of Non Assessable Component In Distribution CGT Effects Of Non Assessable Component In Distribution*

In these circumstances the CGT effects for Delta Pty Ltd of the non assessable component in the distribution will be the same as for Alpha as discussed above. Hence the end effect will be that Delta Pty Ltd will incur a net capital loss of \$800 and will receive a distribution of \$200 entirely tax free with no effect on the cost base of Delta Pty Ltd's units.

**Example 1.3**

*Assume the facts in Example 1 with the variation that the trust derives the capital gain but incurs deductions of \$120,000 for trust law purposes which are not recognised for tax purposes. In these circumstances the trust will have a net income for tax purpose of \$50,000 but will incur a trust loss for trust law purposes of \$20,000. Hence the trust will not make any distribution to unit holders.*

In these circumstances the trustee will be assessed under ITAA 1936 s99A. Here ITAA 1997 s115-225(2)(a) will mean that the amount assessed under s99A is \$50,000 x 2 = \$100,000.

### **Example 2**

*Assume the facts in Example 1 with the variation that the 50% small business discount also applied to the capital gain derived by the trust. Hence when the trustee would advise the unit holders that the \$1000 distributed to each of them consisted of a general 50% discount of \$500 a small business 50% discount of \$250 and a net capital gain of \$250.*

The effects of the distribution of \$1000 to each of the unitholders will be as follows:

#### ***Alpha***

*Assessment of distribution of net capital gain component:*

Share of net capital gain included in assessable income via s97(1)	\$250
Extra capital gain included in assessable income via s115-215(3)(c)	\$1000
Apply 50% discount to s115-215(3)(c) inclusion	\$500
Apply small business 50% discount to s115-215(3)(c) inclusion	\$250
Net s115-215(3)(c) inclusion	\$250
Assessable income	\$500
Deduction under s115-215(6) of the part of the s97(1) inclusion of the trust estate's net capital gain mentioned in s102-5(1)	\$250
Taxable income from distribution	\$250

#### ***CGT Effects Of Non Assessable Component In Distribution***

Calculation of non assessable component for purposes of CGT event E4 s104-70.

Under s104-70(1)(b) the 'non assessable part' will be the part of the distribution that is not included in your assessable income. In Alpha's case this will be \$750 which

represents the 50% discount and the 50% small business discount components in the distribution.

In Alpha's case an adjustment to the non assessable part is then made via Item 1 in the Table in s104-71(4). This will mean that so much of the distribution as reflects the 50% general CGT discount at the trust level ie \$500 will be excluded from the non assessable amount.

Hence in Alpha's case the non assessable amount of the distribution will be \$250 or 25c per unit.. Hence no capital gain will be made by Alpha under s104-70(4) but s104-70(6) will reduce Alpha's cost base by 25c to 75c.

### ***Beta***

*Assessment of distribution of net capital gain component:*

Share of net capital gain included in assessable income via s97(1)	\$250
Extra capital gain included in assessable income via s115-215(3)(c)	\$1000
Capital gain from other share sale	\$400
Capital gain from other share sale after offsetting capital loss of (\$600) against it	\$0
Extra capital gain included via s115-215(3)(c) following offset of balance (\$200) of capital loss	\$800
Apply 50% discount to s115-215(3)(c) inclusion after offsetting of balance of capital loss	\$400
Apply small business 50% discount to s115-215(3)(c) inclusion after offsetting of balance of capital loss	\$200
Net capital gain	\$200
Assessable income	\$450
Deduction under s115-215(6) of the part of the s97(1) inclusion of the trust estate's net capital gain mentioned in s102-5(1)	\$250
Taxable income	\$200

*CGT Effects Of Non Assessable Component In Distribution*

Under s104-70(1)(b) the 'non assessable part' will be the part of the distribution that is not included in your assessable income. In Beta's case this will again be \$750 being the distribution less the s97(1) inclusion.

In Beta's case also an adjustment to the non assessable part is then made via Item 1 in the Table in s104-71(4). This will mean that so much of the distribution as reflects the 50% general CGT discount at the trust level ie \$500 will be excluded from the non assessable amount. A further adjustment will be made under Item 3 in the Table in s104-71(4). This will mean that ¼ of the capital loss of \$600 ie \$150 will be excluded from the non assessable amount. Hence the non assessable part will be reduced \$100 or 10c per unit. Hence, the cost base of Beta's units will be reduced by 10c per unit to 90c.

### ***Gamma Pty Ltd***

*Assessment of distribution of net capital gain component:*

Share of net capital gain included in assessable income via s97(1)	\$250
Extra capital gain included in assessable income via s115-215(3)(c)	\$1000
Apply 50% small business discount to s115-215(3)(c) inclusion	\$500
Net s115-215(3)(c) inclusion	\$500
Assessable income	\$750
Deduction under s115-215(6) of the part of the s97(1) inclusion of the trust estate's net capital gain mentioned in s102-5(1)	\$250
Taxable income from distribution	\$500

### *CGT Effects Of Non Assessable Component In Distribution*

Calculation of non assessable component for purposes of CGT event E4 s104-70.

Under s104-70(1)(b) the 'non assessable part' will be the part of the distribution that is not included in your assessable income. Again, in Gamma's case this will be \$750 being the distribution less the s97(1) inclusion.

In Gamma's case also an adjustment to the non assessable part is then made via Item 1 in the Table in s104-71(4). This will mean that so much of the distribution

as reflects the 50% general CGT discount ie \$500 at the trust level will be excluded from the non assessable amount.

Hence in Gamma's case the non assessable amount of the distribution will be \$250 or 25c per unit. Hence no capital gain will be made by Gamma under s104-70(4) but the cost base of Gamma's units will be reduced by 25c per unit to 75c. The 25c per unit effectively represents the 50% small business concession which has meant that 25c per unit was not included in Gamma Pty Ltd's assessable income via s115-215.

### ***Delta Pty Ltd***

*Assessment of distribution of net capital gain component:*

Share of net capital gain included in assessable income via s97(1)	\$250
Extra capital gain included in assessable income via s115-215(3)(c)	\$1000
Extra capital gain following application of capital loss of \$800 against it	\$200
Apply 50% small business discount to s115-215(3)(c) inclusion following application of capital loss against it	\$100
Net s115-215(3)(c) inclusion	\$100
Assessable income	\$350
Deduction under s115-215(6) of the part of the s97(1) inclusion of the trust estate's net capital gain mentioned in s102-5(1)	\$250
Taxable income from distribution	\$100

### *CGT Effects Of Non Assessable Component In Distribution*

Calculation of non assessable component for purposes of CGT event E4 s104-70.

Under s104-70(1)(b) the 'non assessable part' will be the part of the distribution that is not included in your assessable income. In Delta's case this again will be \$750 being the distribution less the s97(1) inclusion.

In Delta's case also an adjustment to the non assessable part is then made via Item 1 in the Table in s104-71(4). This will mean that so much of the distribution as reflects the 50% general CGT discount ie \$500 at the trust level will be excluded from the non assessable amount. There would be a further adjustment under Item

4 in the Table in s104-71(4) which would mean that the excess of Delta's proportion of the small business reduction applied at the trust level \$250 over the small business reduction of \$100 applied at Delta's level (ie \$150) will further reduce the non assessable amount. Hence the non assessable amount will be \$100 or 10c per unit. This will mean that no capital gain will accrue to Delta but that the cost base of Delta's units will be reduced by 10c to 90c per unit.

### **Example 2.1**

*Assume the facts in Example 2 with the variation that the trust has a revenue loss of \$10,000. This will mean that the trust has a trust income of \$90,000 but a net income of \$15,000 given that the 50% discount and the small business 50% discount will be applied before the revenue loss is offset. Hence the trustee will make a distribution of \$900 to each unit holder and will advise them that \$150 is a distribution of net income assessable under s97(1), that \$500 represents a distribution of the 50% discount and that \$250 represents a distribution of the small business 50% concession.*

The effects of the distribution on the unit holders will be as follows:

#### **Alpha**

*Assessment of distribution of net capital gain component:*

Share of net capital gain included in assessable income via s97(1)	\$150
Extra capital gain included in assessable income via s115-215(3)(c)	\$600 (ie \$150 x 4)
Apply 50% discount to s115-215(3)(c) inclusion	\$300
Apply small business 50% discount to s115-215(3)(c) inclusion	\$150
Net s115-215(3)(c) inclusion	\$150
Assessable income	\$300
Deduction under s115-215(6) of the part of the s97(1) inclusion of the trust estate's net capital gain mentioned in s102-5(1)	\$150
Taxable income from distribution	\$150

#### *CGT Effects Of Non Assessable Component In Distribution*

Calculation of non assessable component for purposes of CGT event E4 s104-70.

Under s104-70(1)(b) the 'non assessable part' will be the part of the distribution that is not included in your assessable income. In Alpha's case this will be \$750 which represents the 50% discount and the 50% small business discount components in the distribution.

In Alpha's case an adjustment to the non assessable part is then made via Item 1 in the Table in s104-71(4). This will mean that so much of the distribution as reflects the 50% general CGT discount at the trust level ie \$500 will be excluded from the non assessable amount.

Hence in Alpha's case the non assessable amount of the distribution will be \$250 or 25c per unit. Hence no capital gain will be made by Alpha under s104-70(4) but s104-70(6) will reduce Alpha's cost base by 25c to 75c.

### **Beta**

*Assessment of distribution of net capital gain component:*

Share of net capital gain included in assessable income via s97(1)	\$150
Extra capital gain included in assessable income via s115-215(3)(c)	\$600 (ie \$150 x 4)
Capital gain from other share sale	\$400
Capital gain from other share sale after offsetting capital loss of (\$600) against it	\$0
Extra capital gain included via s115-215(3)(c) following offset of balance (\$200) of capital loss	\$400
Apply 50% discount to s115-215(3)(c) inclusion after offsetting of balance of capital loss	\$200
Apply small business 50% discount to s115-215(3)(c) inclusion after offsetting of balance of capital loss	\$100
Net capital gain	\$100
Assessable income	\$250
Deduction under s115-215(6) of the part of the s97(1) inclusion of the trust estate's net capital gain mentioned in s102-5(1)	\$150
Taxable income	\$100

*CGT Effects Of Non Assessable Component In Distribution*

Under s104-70(1)(b) the 'non assessable part' will be the part of the distribution that is not included in your assessable income. In Beta's case this will again be \$750 being the distribution less the s97(1) inclusion.

In Beta's case also an adjustment to the non assessable part is then made via Item 1 in the Table in s104-71(4). This will mean that so much of the distribution as reflects the 50% general CGT discount at the trust level ie \$500 will be excluded from the non assessable amount. A further adjustment will be made under Item 3 in the Table in s104-71(4). This will mean that ¼ of the capital loss of \$600 ie \$150 will be excluded from the non assessable amount. Hence the non assessable part will be reduced by \$100 or 10c per unit. Hence, there will be no derivation of a capital gain by Beta but the cost base of Beta's units will be reduced by 10c per unit to 90c.

### ***Gamma Pty Ltd***

*Assessment of distribution of net capital gain component:*

Share of net capital gain included in assessable income via s97(1)	\$150
Extra capital gain included in assessable income via s115-215(3)(c)	\$600 (ie \$150 x 4)
Apply 50% small business discount to s115-215(3)(c) inclusion	\$300
Net s115-215(3)(c) inclusion	\$300
Assessable income	\$450
Deduction under s115-215(6) of the part of the s97(1) inclusion of the trust estate's net capital gain mentioned in s102-5(1)	\$150
Taxable income from distribution	\$300

### *CGT Effects Of Non Assessable Component In Distribution*

Calculation of non assessable component for purposes of CGT event E4 s104-70.

Under s104-70(1)(b) the 'non assessable part' will be the part of the distribution that is not included in your assessable income. Again, in Gamma's case this will be \$750 being the distribution less the s97(1) inclusion.

In Gamma's case also an adjustment to the non assessable part is then made via Item 1 in the Table in s104-71(4). This will mean that so much of the distribution

as reflects the 50% general CGT discount ie \$500 at the trust level will be excluded from the non assessable amount.

Hence in Gamma's case the non assessable amount of the distribution will be \$250 or 25c per unit. Hence no capital gain will be made by Gamma under s104-70(4) but the cost base of Gamma's units will be reduced by 25c per unit to 75c. The 25c per unit effectively represents the 50% small business concession which has meant that 25c per unit was not included in Gamma Pty Ltd's assessable income via s115-215.

### ***Delta Pty Ltd***

*Assessment of distribution of net capital gain component:*

Share of net capital gain included in assessable income via s97(1)	\$150
Extra capital gain included in assessable income via s115-215(3)(c)	\$600 (ie \$150 x 4)
Net capital loss following application of capital loss of \$800	(\$200)
Assessable income	\$150
Deduction under s115-215(6) of the part of the s97(1) inclusion of the trust estate's net capital gain mentioned in s102-5(1)	\$150
Taxable income from distribution	\$0

### *CGT Effects Of Non Assessable Component In Distribution*

Calculation of non assessable component for purposes of CGT event E4 s104-70.

Under s104-70(1)(b) the 'non assessable part' will be the part of the distribution that is not included in your assessable income. In Delta's case this again will be \$750 being the distribution less the s97(1) inclusion.

In Delta's case also an adjustment to the non assessable part is then made via Item 1 in the Table in s104-71(4). This will mean that so much of the distribution as reflects the 50% general CGT discount ie \$500 at the trust level will be excluded from the non assessable amount. There is no further adjustment under Item 4 in the Table in s104-71(4) as there is no Subdivision 152-C reduction at Delta's level as the capital loss offset has meant that there is no capital gain to reduce.

### **Example 2.2**

Assume the facts in Example 2 with the variation that the trust has a revenue loss from other operations of \$80,000. This will mean that it has a trust income of \$20,000 but incurs a trust loss of (\$55,000) for tax purposes. The trustee makes a distribution of \$200 to each unit holder and advises them that this represents the 50% general CGT discount.

The effects of the distribution on the unit holders will be as follows:

### **Alpha**

*Assessable income aspects:*

No inclusions in assessable income.

### *CGT Effects Of Non Assessable Component In Distribution*

Calculation of non assessable component for purposes of CGT event E4 s104-70.

Under s104-70(1)(b) the 'non assessable part' will be the part of the distribution that is not included in your assessable income. In Alpha's case this will be \$200 which represents the 50% discount.

In Alpha's case an adjustment to the non assessable part is then made via Item 1 in the Table in s104-71(4). This will mean that so much of the distribution as reflects the 50% general CGT discount at the trust level ie \$200 will be excluded from the non assessable amount.

Hence in Alpha's case the \$200 will be distributed entirely tax free will have no effect on the cost base of Alpha's units.

### **Beta**

*Assessable income effects of distribution:*

Capital gain from other share sale	\$400
Net capital loss after offsetting of capital loss (\$600) against capital gain from share sale.	(\$200)

### *CGT Effects Of Non Assessable Component In Distribution*

Under s104-70(1)(b) the 'non assessable part' will be the part of the distribution that is not included in your assessable income. In Beta's case this will again be \$200.

In Beta's case also an adjustment to the non assessable part is then made via Item 1 in the Table in s104-71(4). This will mean that so much of the distribution as reflects the 50% general CGT discount at the trust level ie \$500 will be excluded from the non assessable amount. No further adjustment will be made under Item 3 in the Table in s104-71(4) as Beta has no s115-215(3)(c) inclusion.

Hence the distribution of \$200 to Beta will be tax free and will not reduce the cost base of Beta'

### ***Gamma Pty Ltd***

*Assessable income aspects:*

No inclusions in assessable income.

### *CGT Effects Of Non Assessable Component In Distribution*

Calculation of non assessable component for purposes of CGT event E4 s104-70.

Under s104-70(1)(b)the 'non assessable part' will be the part of the distribution that is not included in your assessable income. Again, in Gamma's case this will be \$200.

In Gamma's case also an adjustment to the non assessable part is then made via Item 1 in the Table in s104-71(4). This will mean that so much of the distribution as reflects the 50% general CGT discount ie \$200 at the trust level will be excluded from the non assessable amount.

Hence in Gamma's case the distribution of \$200 is entirely tax free and does not affect the cost base of Gamma's units.

### ***Delta Pty Ltd***

*Assessable income aspects*

Net capital loss \$800

### *CGT Effects Of Non Assessable Component In Distribution*

Calculation of non assessable component for purposes of CGT event E4 s104-70.

Under s104-70(1)(b)the 'non assessable part' will be the part of the distribution that is not included in your assessable income. In Delta's case this again will be \$200.

In Delta's case also an adjustment to the non assessable part is then made via Item 1 in the Table in s104-71(4). This will mean that so much of the distribution as reflects the 50% general CGT discount ie \$200 at the trust level will be excluded from the non assessable amount. There is no further adjustment under Item 4 in the Table in s104-71(4) as there is no Subdivision 152-C reduction at Delta's level as the capital loss offset has meant that there is no capital gain to reduce.

Hence the distribution of \$200 will be entirely tax free to Delta Pty Ltd and will not have any effect on the cost base of Delta Pty Ltd's units.

### **Example 2.3**

*Assume the facts in Example 2 with the variation that the trust derives the capital gain but incurs deductions of \$120,000 for trust law purposes which are not recognised for tax purposes. In these circumstances the trust will have a net income for tax purpose of \$25,000 but will incur a trust loss for trust law purposes of \$20,000. Hence the trust will not make any distribution to unit holders.*

In these circumstances the trustee will be assessed under ITAA 1936 s99A. Here ITAA 1997 s115-225(2)(b) will mean that the amount assessed under s99A is \$25,000 x 4 = \$100,000.

### **Example 3**

*Assume the facts in Example 1 with the variation that \$500 of the distribution to each unit holder is attributable to a non discounted net capital gain taken into account in the trust's s95 calculation and \$500 (being the unitholder's proportion of the excess of trust income over net income) was attributable to Division 43 deductions being allowed for tax purposes only.*

The effects of the distribution of \$1000 to each of the unitholders will be as follows:

#### ***Alpha***

*Assessment of distribution of net capital gain component:*

Share of net capital gain included in assessable income via s97(1)	\$500
Extra capital gain included in assessable income via s115-215(3)(b)	\$500
Assessable income	\$1000
Deduction under s115-215(6) of the part of the s97(1) inclusion of the trust estate's net capital gain mentioned in s102-5(1)	\$500
Taxable income from distribution	\$500

#### ***CGT Effects Of Non Assessable Component In Distribution***

Calculation of non assessable component for purposes of CGT event E4 s104-70.

Under s104-70(1)(b) the 'non assessable part' will be the part of the distribution that is not included in your assessable income. In Alpha's case this will be \$500 being the distribution less the amount assessable under s97(1).

Hence in Alpha's case the non assessable amount of the distribution will be \$500 or 50c per unit. Hence no capital gain will be made by Alpha under s104-70(4) but s104-70(6) will reduce the cost base of Alpha's units by 50c per unit to 50c.

### ***Beta***

#### *Assessment of distribution of net capital gain component:*

Share of net capital gain included in assessable income via s97(1)	\$500
Extra capital gain included in assessable income via s115-215(3)(b)	\$500
Net capital loss following offsetting of capital loss of \$600 against extra capital gain	(\$100)
Assessable income	\$500
Deduction under s115-215(6) of the part of the s97(1) inclusion of the trust estate's net capital gain mentioned in s102-5(1)	\$500
Taxable income from distribution	\$0

#### *CGT Effects Of Non Assessable Component In Distribution*

Calculation of non assessable component for purposes of CGT event E4 s104-70.

Under s104-70(1)(b) the 'non assessable part' will be the part of the distribution that is not included in your assessable income. In Beta's case this will be \$500 being the distribution less the amount assessable under s97(1).

Hence in Beta's case the non assessable amount of the distribution will be \$500 or 50c per unit. Hence no capital gain will be made by Beta under s104-70(4) but s104-70(6) will reduce the cost base of Beta's units by 50c per unit to 50c.

### ***Gamma Pty Ltd***

Gamma Pty Ltd's position in these circumstances will be the same as Alpha's.

### ***Delta Pty Ltd***

#### *Assessment of distribution of net capital gain component:*

Share of net capital gain included in assessable income via s97(1)	\$500
Extra capital gain included in assessable income via s115-215(3)(b)	\$500
Net capital loss following offsetting of capital loss of \$800 against extra capital gain	(\$300)
Assessable income	\$500
Deduction under s115-215(6) of the part of the s97(1) inclusion of the trust estate's net capital gain mentioned in s102-5(1)	\$500
Taxable income from distribution	\$0

#### *CGT Effects Of Non Assessable Component In Distribution*

Calculation of non assessable component for purposes of CGT event E4 s104-70.

Under s104-70(1)(b) the 'non assessable part' will be the part of the distribution that is not included in your assessable income. In Delta's case this will be \$500 being the distribution less the amount assessable under s97(1).

Hence in Delta's case the non assessable amount of the distribution will be \$500 or 50c per unit. Hence no capital gain will be made by Delta under s104-70(4) but s104-70(6) will reduce the cost base of Delta's units by 50c per unit to 50c.

#### ***IV: Causes Of Complexity In The Interaction Of These Provisions***

The above Examples are relatively simple but nonetheless calculation of the beneficiary's capital gains and of the effect of CGT event E4 on the cost base of the beneficiary's interest or units in the trust is highly complex. In a general sense the case studies are illustrative of the 1<sup>st</sup>, 2<sup>nd</sup>, 10<sup>th</sup>, 11<sup>th</sup> and 12<sup>th</sup> causes of complexity noted above. The use of income as a tax base, its supplementation by

a capital gains tax regime which provides concessional tax treatment for some capital gains, the quarantining of capital losses, and varying policies on the pass through of preferences through trusts all contribute to the complexity of these provisions. Any provisions implementing such policies are bound to be complex but some features of the operational rules giving effect to these policies arguably exacerbate this inevitable complexity.

Some more particular causes of the complexity of these provisions appear to be:

- **Complex policy choices mean that a large number of CGT concessions operate at trust level and different treatments are accorded to several of them on distribution**

As the above examples show the treatment at the beneficiary level of distributions representing an excess the income of the trust estate over the net income of the trust estate differs according to the type of tax preferred income that is distributed.

Where the excess is due to the general 50% discount component in a capital gain made by the trust a distribution of the excess is not taxable to the beneficiary and does not reduce the cost base of the beneficiary's interest in the trust. Where the beneficiary has capital losses or net capital losses these are absorbed against the grossed up capital gain portion of the distribution and hence may reduce the value of the discount to the beneficiary. The grossing up of the capital gain component in the distribution at the beneficiary level and the reapplication of the discount at the beneficiary level is to implement the general policy that capital losses should be offset against capital gains before any general discounts are applied. Where the beneficiary is a company the gross up occurs but no discount is allowed with the result that the capital gain is given equivalent treatment to that it would have received if it had been derived directly by the company.

Where the excess is due to the small business 50% discount a distribution of the excess is not immediately assessable to the beneficiary but reduces the cost base of the beneficiary's interest in the trust. For both individual and corporate beneficiaries the excess is grossed up and capital losses and net capital losses are absorbed against the grossed up distribution before the small business discount is applied.

Where the excess is due to a gain on a pre CGT asset a distribution of the excess is not immediately assessable to the beneficiary but reduces the cost base of the beneficiary's interest in the trust. The distribution is not grossed up and the beneficiary's share of the net income of the trust estate is assessable via ITAA36 Div 6 (for example under s97(1)). No gross up or replication of the discount occurs as no discount arose at the trust level and as no taxable capital gain was derived by the trust.

Similarly, where the excess is due to Division 43 deductions being available to the trust, a distribution of the excess is not immediately assessable to the beneficiary but reduces the cost base of the beneficiary's interest in the trust. Again, for the same reasons as applied in the case of a distribution of a gain on a pre CGT asset,

the distribution is not grossed up and the beneficiary's share of the net income of the trust estate is assessed via Div 6 of ITAA36.

Hence it can be seen any one of the following treatments of a distribution of the excess can occur at the beneficiary level:

- Not immediately assessable on distribution; reduction in cost base; grossed up for purposes of capital loss offsetting.
- Not immediately assessable on distribution; no reduction in cost base; grossed up for purposes of capital loss offsetting;
- Not immediately assessable on distribution; reduction in cost base; not grossed up for purposes of capital loss offsetting;
- **Drafter's approach to implementing the ordering rule for application of capital losses and discounts at the beneficiary level exacerbates complex policy choices**

The complexities produced by the complex policy choices are exacerbated by practical problems associated with implementing them. The policy of grossing up the distribution so as to offset capital losses before applying the general or small business 50% discounts and the approach adopted by the drafter has resulted in the amount of the gross varying according to whether only one of or both of the discounts was taken into account at the trust level. There is also artificiality in grossing up the capital gains component by the multiplication method in all situations rather than by simply adding together the various capital gains and discount components in the distribution. It will be seen subsequently that some form of multiplication appears to be necessary in some circumstances but that its use can be confined to particular situations.

- **Organisation Of Provisions Promotes Consideration Of Items Irrelevant To Many Taxpayers**

For unit holders in a listed unit trust many of the items in s104-71 and in s115-215 would be irrelevant (eg small business concessions (15 year in s104-71 and 50% discount in s115-215, PSI 86-15 exemption).

For many unit holders the items in s104-71(3) would be irrelevant (ie exempt income arising from shares in PDF and infrastructure borrowings).

Simplicity would be improved by a differently organised provision which stated the general rule or the rule for the most common situations first and then stated the rules for more unusual circumstances. Also a general statement of the policy intent of the rules would be helpful.

- **The Inclusion Of The Capital Gains Component In The s97(1) Amount In Assessable Income And Its Subsequent Subtraction**

When s115-215 is looked at in isolation the inclusion of the capital gains component in the s97 (1) amount in assessable income and its subsequent subtraction appears to be an unnecessary and complicating step. It may be that the drafter did this to simplify the identification of the non assessable amount in s104-71. Nonetheless, the redraft below endeavours to show that it would be possible to have merely one inclusion in assessable income in these circumstances.

- **Shifting Perspective From Which Provisions View The Distribution**

In calculating the non assessable amount in s104-71 the perspective from which the distribution is characterised shifts several times. In some instances the characterisation is made by reference to the composition and calculation of the net income of the trust estate in other instances the characterisation is made by reference to the composition and calculation of capital gains at the beneficiary level. This can cause uncertainty as to which perspective is being adopted for characterisation purposes.

- **Present Entitlement v Realisation Basis**

Derivation of income under Division 6 of Part III of *Income Tax Assessment Act* 1936 is on the basis of present entitlement to shares of trust income. CGT event E4, by contrast, adjusts cost base when actual distributions are made. This contributes to what appear to be anomalous results where distributions of trust income are made when there is no net income of the trust estate for tax purposes.

**V: *A Possible Redraft Of Provisions Relevant To Distributions Of Capital Gains And Tax Preferred Amounts By A Trustee***

After attempting to redraft these provisions I was reminded of the famous statement by Winston Churchill about Parliamentary democracy, that it looked like a terrible system until you tried to design a better one. I found that the process of attempting to redraft the provisions in a manner which removed many of the causes of complexity noted above made the logic that led to the structure of the present provisions apparent. Nonetheless, it will be submitted that the following redraft does reduce both the legal and effective complexity of the provisions dealing with the movement of capital gains tax preferences through trusts.

A redraft of these provisions would need to be accompanied by some redrafting of Division 6 of Part III of ITAA36. The redraft below proceeds on the basis that the point of taxation of trust distributions to presently entitled beneficiaries would be changed to the point of actual distribution to those beneficiaries rather than the point of entitlement.<sup>23</sup> In redrafting these provisions a presently entitled resident beneficiary not under a legal disability has been taken as the paradigm case. Similar provisions could be drafted for each of the situations currently dealt with in s115-215 and s104-71.

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<sup>23</sup> Space does not permit detailed argument in favour of this approach to the taxation of trusts. What is envisaged is that retained trust income would be taxed at the trust level with some form of relief being given to distributions of trust income that had previously been taxed.

### ***Proposed Redraft***

- A. *The intended effect of operation of these rules is to produce an equivalent result where a net capital gain flows through a trust estate to a beneficiary to the result that would be produced if the components capital gain had been derived by the beneficiary as an individual or as a company as the case may be. The rules are intended to produce the result that capital losses incurred at the beneficiary level are applied against the components of that capital gain consistently with the rules in this Act governing the application of capital losses for individuals and companies generally. The rules are also intended to produce the result that the application of various CGT concessions, such as the CGT discount and the small business discount, operate consistently with the rules in this Act governing the application of those concessions to taxpayers who do not derive capital gains through an interposed entity.*
- B. *Operative Rules For The Taxation At The Beneficiary Level Of Distributions Of Net Capital Gains*
1. *Where a resident beneficiary who is not under a legal disability is paid a proportion, to which the beneficiary is presently entitled, of the income a trust estate the following provisions shall apply:*
- (a) *that proportion of the net income of the trust estate, except so much of the net income as is attributable to a net capital gain being derived by the trust estate, is included in the assessable income of the beneficiary (the beneficiary's assessable amount);*
  - (b) *for each capital gain taken into account in calculating the net income of the trust estate the beneficiary shall derive an extra capital gain equal to the sum of that proportion of: (i) each capital gain so taken into account following the application of step 4 in the method statement in s102-5(1); (ii) the amount of any reduction under step 3 in the method statement in s102-5(1) taken into account in calculating the capital gain; and (iii) the amount of any reduction under Subdivision 152-C taken into account in calculating the capital gain.*
  - (c) *where but for the inclusion of capital gains the trust's ITAA 1936 s95 calculation would have produced a trust loss and neither paragraph (b)(ii) nor (b)(iii) applies then the amount of the loss that would have been so produced is a notional trust loss amount but where either paragraph (b)(ii) or (b)(iii) applies then the notional trust loss amount is the amount of the loss that would have been so produced multiplied by two and where both paragraph (b)(ii) and (b)(iii) apply the notional trust loss amount is the amount of the loss that would have been so produced multiplied by four.*

(d) *the sum of each of the extra capital gains calculated in paragraph (b) less the that proportion of the notional trust loss amount as determined in paragraph (c) represents the beneficiary's extra capital gains amount.*

2. *Where sub section (1) applies the Trustee shall provide all beneficiaries to whom a payment is made with a notice:*

(a) *stating the beneficiary's assessable amount and that this amount is included in the beneficiary's assessable income;*

(b) *stating the amount of each extra capital gain to be derived by the beneficiary stating whether and to what extent each extra capital gain includes B(1)(b)(ii) and B1(b)(iii) amounts respectively and whether and to what extent the extra capital gain has been reduced by a proportion of the notional trust loss;*

(c) *advising the beneficiary to treat each extra capital gain as an extra capital gain that the beneficiary has;*

(d) *advising the beneficiary that in respect of each extra capital gain that includes a B(1)(b)(ii) amount Division 102 applies as if that extra capital gain were a discount capital gain;*

(e) *advising the beneficiary that in respect of each extra capital gain that includes a B(1)(b)(iii) amount the capital gain remaining after applying Step 3 in the method statement in s102-5(1) is reduced by 50%.*

(f) *where a distribution is made by a trust that does not have a net income for the purposes of ITAA 1936 s95, advising the beneficiary of whether and to what extent the distribution represents a proportion of: the amount of any reduction under step 3 in the method statement in s102-5(1) taken into account in calculating each capital gain taken into account in the trust's ITAA 1936 s95 calculation.*

C. *Operative Rules For CGT Effects Of Distributions Of Tax Preferred Amounts By Trusts*

1. *CGT event E4 happens when a trustee makes a payment, including a giving of property, to a beneficiary in respect of the beneficiary's unit or interest in a trust (except where CGT event A1, C2, E1, E6 or E7 happens in relation to the payment) and the payment includes a non assessable part..*

1. *The time of the event is [as per existing s104-70(3)];*

2. *If the non assessable part of the payment is not more than the cost base of the unit or interest then:*

(a) *the cost base of the unit or interest is reduced by the non assessable part of the payment; and*

(b) *the reduced cost base of the unit or interest is reduced by the non assessable part of the payment (without the adjustment in s104-71(3)).*

3. *If the non assessable part of the payment is more than the cost base of the unit or interest then the beneficiary makes a capital gain equal the non assessable parts of the payment minus the cost base.*
4. *Where the beneficiary makes a capital gain the cost base and the reduced cost base of the unit or interest are reduced to nil.*
5. *The non assessable part of a payment is calculated as set out in D below.*

*D. Calculation Of Non Assessable Part Of Distribution By Trustee*

1. *This section sets out how to calculate the non assessable part of a payment for the purposes of C above.*
2. *The non assessable part includes any amount paid to the beneficiary other than amounts referred to in D3 below.*
2. *To the extent that a payment is deductible to a beneficiary it is included in the non assessable part.*
3. *The non assessable part of a payment does not include an amount that is:*
  - (a) *non assessable non exempt income;*
  - (b) *assessable to the beneficiary under B(2)(a) above;*
  - (c) *an extra capital gain that was added under B(1)(b)(i) in calculating the beneficiary's extra capital gains amount;*
  - (d) *an extra capital gain that was added under B(1) (b) (ii) in calculating the beneficiary's extra capital gains amount;*
  - (e) *referred to in s152-125 as an exempt amount;*
  - (f) *paid from an amount that has been assessed to the trustee;*
  - (g) *repaid by the beneficiary to the extent that the repayment;*
  - (h) *compensation you paid that can reasonably be regarded as a repayment of all or part of the payment;*
  - (i) *paid from an amount of personal services income included in the beneficiary's assessable income or another entity's assessable income under s86-15;*
  - (j) *attributable to income that is not included in the assessable income of any entity because of s124ZM or 124ZN or s159GZZZZE;*

(j) *attributable to the proceeds from a CGT event happening in relation to shares in a company that was a PDF when that event happened;*

(k) *an amount referred to in B(2)(f).*

4. *Notwithstanding D3, to the extent that a payment is deductible to a beneficiary it is included in the non assessable part.*

*Where capital loss or net capital loss applied by beneficiary against extra capital gain which includes B(1)(b)(iii) amount and no B(1)(b)(ii) amount*

5. *Where a beneficiary (other than a complying superannuation entity) has applied a capital loss or a net capital loss to reduce one of the beneficiary's extra capital gains which included an amount referred to in B(1)(b)(iii) above and that extra capital gain did not include an amount derived under B(1)(b)(ii) above, then, in calculating the non assessable amount, subtract one half of the capital loss or net capital loss so applied..*

*Where capital loss or net capital loss applied by beneficiary against extra capital gain which includes B(1)(b)(ii) and B(1)(b)(iii) amounts*

6. *Where a beneficiary (other than a company or a complying superannuation entity) has applied a capital loss or a net capital loss to reduce an extra capital gain which included an amount referred to in B(1)(b)(ii) above and an amount referred to in B(1)(b)(iii) above, then, in calculating the non assessable amount, subtract one quarter of the capital loss or net capital loss so applied.*

*Where company applies net capital loss to reduce extra capital gain which included B(1)(b)(ii) and B(1)(b)(iii) amounts*

7. *Where:*

(i) *a company has applied a capital loss or a net capital loss to reduce an extra capital gain and the amount of capital loss or net capital loss is more than one half of the extra capital gain; and*

(ii) *an amount referred to in B(1)(b)(ii) and an amount referred to in B(1)(b)(iii) was taken into account in calculating the extra capital gain; and*

(iii) *the beneficiary obtained a Subdivision 152-C reduction in relation to the extra capital gain.*

*in calculating the non assessable part subtract the excess of the reduction under Subdivision 152-C taken into account in calculating that capital gain in the trust's net income calculation over any Subdivision 152-C reduction that the beneficiary company obtains in relation to the extra capital gain.*

*Similar provisions having an equivalent effect to items 5 and 6 in the Table in s104-71(4) would also be inserted here*

As long as the fundamental policy choices currently expressed in the interaction of CGT Event E4 with the rules relating to capital gains passing through trusts, ordering rules for offsetting of capital losses and the application of discounts and small business concessions, are maintained any operational rules giving effect to those policies will be complex. In fact the case studies highlight the compounding effects when discrete causes of complexity interact.

## **VI: Examples Of Application Of Suggested Redraft**

### **Example 4**

Assume the facts in *Example 1* above. The suggested redraft would apply in that situation as follows:

#### ***Alpha***

B(1)(a) inclusion in beneficiary's assessable income = zero

The amount is zero as, in this situation, all of the distribution of net income represents capital gains derived by trust.

B(1)(b) inclusion (status of component parts of payment shown on trustee's statement to beneficiaries)

- (i) \$500 [capital gain taken into account at trust level following the application of step 4 in the method statement in s102-5(1)];
- (ii) \$500 [amount of reduction under step 3 in the method statement in s102-5(1)].

Total extra capital gain:	\$1000
Apply 50% discount:	\$ 500
Taxable income from distribution:	\$ 500

Non assessable part = zero via D(3)(c) and D3(d)

#### ***Beta***

B(1)(a) inclusion = zero

Total extra capital gain	\$1000 (as calculated as for Alpha above)
Capital gain on other share sale	\$ 400
Capital loss	(\$ 600)
Extra capital gain after offsetting balance of capital loss*	\$ 800
Apply 50% discount	\$ 400
Taxable income	\$ 400

Non assessable amount = zero via D3(c) and D3(d).

\* Assumption is made that beneficiary chooses to offset the capital loss against the undiscounted capital gain on the sale of other shares first. The balance of the capital loss is then set off against the extra capital gains on which a 50% discount is available.

***Gamma Pty Ltd***

B(1)(a) inclusion = zero

Total extra capital gain	\$1000 (as calculated as for Alpha above)
Taxable income	\$1000

Non assessable amount = zero via D3(c) and D3(d).

***Delta Pty Ltd***

B(1)(a) inclusion = zero

Total extra capital gain	\$1000 (as calculated as for Alpha above)
Capital loss offset	(\$ 800)
Taxable income	\$ 200

Non assessable amount = zero via D3(c) and D3(d).

**Example 4.1**

Assume the facts in *Example 1.1* above. The suggested redraft would apply in that situation as follows:

***Alpha***

B(1)(a) inclusion in beneficiary's assessable income = zero

The amount is zero as, in this situation, all of the distribution of net income represents capital gains derived by trust.

B(1)(b) inclusion (status of component parts of payment shown on trustee's statement to beneficiaries)

- (i) \$500 [capital gain taken into account at trust level following the application of step 4 in the method statement in s102-5(1)];
- (iii) \$500 [amount of reduction under step 3 in the method statement in s102-5(1)].

B(1)(c) notional trust loss amount  $\$100 \times 2 = \$200$

B(1)(d)

Total extra capital gain less B(1)(c):	\$ 800
Apply 50% discount:	\$ 400

Taxable income from distribution: \$ 400

Non assessable part = zero via D(3)(c) and D3(d)

***Beta***

B(1)(a) inclusion = zero

Total extra capital gain less B(1)(c)	\$ 800 (as calculated as for Alpha above)
Capital gain on other share sale	\$ 400
Capital loss	(\$ 600)
Extra capital gain after offsetting balance of capital loss*	\$ 600
Apply 50% discount	\$ 300
Taxable income	\$ 300

Non assessable amount = zero via D3(c) and D3(d).

\* Assumption is made that beneficiary chooses to offset the capital loss against the undiscounted capital gain on the sale of other shares first. The balance of the capital loss is then set off against the extra capital gains on which a 50% discount is available.

***Gamma Pty Ltd***

B(1)(a) inclusion = zero

Total extra capital gain	
less B(1)(c)	\$ 800 (as calculated as for Alpha above)
Taxable income	\$ 800

Non assessable amount = zero via D3(c) and D3(d).

***Delta Pty Ltd***

B(1)(a) inclusion = zero

Total extra capital gain	
less B(1)(c)	\$ 800 (as calculated as for Alpha above)
Capital loss offset	(\$ 800)
Taxable income	\$ 0

Non assessable amount = zero via D3(c) and D3(d).

**Example 4.2**

Assume the facts in *Example 1.2* above. The suggested redraft would apply in that situation as follows:

In this situation there would be no B(1)(a) or B(1)(b) amounts for any beneficiaries. Hence there would not be any B(1)(d) inclusions for any beneficiaries.

Item D(3)(k) would mean that the distribution of \$200 was not included in the non assessable part of the distribution and hence did not reduce the cost base of the units of any of the beneficiaries.

### **Example 4.3**

Assume the facts in *Example 1.3*. Here consideration would need to be given to whether a redraft of s115-225 was necessary. Consistently with the balance of the redraft it would be possible to distinguish between the situation where there are no offsetting deductions or losses at the trust level for tax purposes and the situation where there are such offsetting deductions or losses. In the former situation it would be possible to simply add the component elements of the capital gain and various discounts that no beneficiary was presently entitled to. In the latter situation it would once again be necessary to calculate a notional loss and to multiply it by two when only the 50% CGT discount or the 50% small business concession had applied at the trust level and to multiply it by four when both the 50% CGT discount and the 50% small business concession had applied at the trust level. The grossed up loss would then be deducted from the sum of the component elements of the capital gain and the various discounts to arrive at an amount on which the trustee would be assessed under s99A.

### **Example 5**

Assume the facts in *Example 2* above. The suggested redraft would apply in that situation as follows:

#### *Alpha*

B(1)(a) inclusion = zero

The amount is zero as, in this situation, all of the distribution of net income represents capital gains derived by trust.

B(1)(b) inclusion (status of component parts of payment shown on trustee's statement to beneficiaries)

- (i) \$250  
[capital gain taken into account at trust level following the application of step 4 in the method statement in s102-5(1)];
- (ii) \$500  
[amount of reduction under step 3 in the method statement in s102-5(1)];
- (iii) \$250

[amount of reduction under Subdivision 152-C taken into account in calculating the capital gain.]

Total extra capital gains	\$1000
Apply 50% discount	\$ 500
Apply small business 50% discount	\$ 250
Taxable income from distribution	\$ 250

Non assessable distribution \$250 being the B(1)(b)(iii) amount via the combined operation of D2 and D3.

Cost base of beneficiary's interest is reduced by \$250 under C2.

### ***Beta***

B(1)(a) inclusion = zero

Total extra capital gains	\$1000 (as calculated as for Alpha above)
Capital gain on other share sale	\$ 400
Capital loss	(\$ 600)
Extra capital gain after offsetting balance of capital loss*	\$ 800
Apply 50% discount	\$ 400
Apply small business 50% discount	\$ 200
Taxable income from distribution	\$ 200

\* Assumption is made that beneficiary chooses to offset the capital loss against the undiscounted capital gain on the sale of other shares first. The balance of the capital loss is then set off against the extra capital gains on which a 50% discount is available.

In calculating the non assessable amount the combined operation of D2, D3 and D6 requires that the B(1)(b)(iii) amount of \$250 be reduced by the capital loss offset of \$600 divided by 4 = \$150. This produces a non assessable amount of \$100. The cost base of the beneficiary's interest is reduced by \$100.

### ***Gamma Pty Ltd***

B(1)(a) inclusion = zero

Total extra capital gains	\$1000 (as calculated as for Alpha above)
Apply small business 50% discount	\$ 500
Taxable income from distribution	\$ 500

Non assessable distribution \$250 being the B(1)(b)(iii) amount via the combined operation of D2 and D3.

Hence the cost base of the beneficiary's interest will be reduced by \$250.

***Delta Pty Ltd***

B(1)(a) inclusion = zero

Total extra capital gains	\$1000 (as calculated as for Alpha above)
Offset capital loss	(\$ 800)
Extra capital gains after loss offset	\$ 200
Apply small business 50% discount	\$ 100
Taxable income from distribution	\$ 100

The B(1)(b)(iii) amount of \$250 is included in the non assessable amount via the combined operation of D2 and D3. The non assessable amount is reduced by \$150 via D7. The result is that the non assessable amount is \$100. Hence the cost base of the beneficiary's interest is reduced by \$100.

**Example 5.1**

Assume the facts in *Example 2.1* above. The suggested redraft would apply in that situation as follows:

***Alpha***

B(1)(a) inclusion in beneficiary's assessable income = zero

The amount is zero as, in this situation, all of the distribution of net income represents capital gains derived by trust.

B(1)(b) inclusion (status of component parts of payment shown on trustee's statement to beneficiaries)

- (i) \$250 [capital gain taken into account at trust level following the application of step 4 in the method statement in s102-5(1)];
- (ii) \$500 [amount of reduction under step 3 in the method statement in s102-5(1)].
- (iii) \$250 [amount of reduction under Subdivision 152-C]

B(1)(c) notional trust loss amount  $\$100 \times 4 = \$400$

B(1)(d)

Total extra capital gain less B(1)(c):	\$ 600
Apply 50% discount:	\$ 300
Apply 50% small business concession	\$ 150
Taxable income from distribution:	\$ 150

Item D(3)(c) excludes \$250 from the non assessable amount and item D(3)(d) excludes \$500 from the non assessable amount. Hence C2 reduces the cost base of Alpha's units by \$250 being the non assessable amount.

**Beta**

B(1)(a) inclusion = zero

Total extra capital gain less B(1)(c)	\$ 600 (as calculated as for Alpha above)
Capital gain on other share sale	\$ 400
Capital loss	(\$ 600)
Extra capital gain after offsetting balance of capital loss*	\$ 400
Apply 50% discount	\$ 200
Taxable income	\$ 200

Item D(3)(c) excludes \$250 from the non assessable amount and item D(3)(d) excludes \$500 from the non assessable amount. In addition item 6 further reduces the non assessable amount by one quarter of the capital loss of \$600 ie by \$150. Hence C2 reduces the cost base of Beta's units by \$100 being the non assessable part.

\* Assumption is made that beneficiary chooses to offset the capital loss against the undiscounted capital gain on the sale of other shares first. The balance of the capital loss is then set off against the extra capital gains on which a 50% discount is available.

**Gamma Pty Ltd**

B(1)(a) inclusion = zero

Total extra capital gain	
less B(1)(c)	\$ 600 (as calculated as for Alpha above)
Taxable income	\$ 600

Item D(3)(c) excludes \$250 from the non assessable amount and item D(3)(d) excludes \$500 from the non assessable amount. Hence C2 reduces the cost base of Gamma Pty Ltd 's units by \$250 being the non assessable amount.

**Delta Pty Ltd**

B(1)(a) inclusion = zero

Total extra capital gain	
less B(1)(c)	\$ 600 (as calculated as for Alpha above)
Capital loss offset	(\$ 800)
Net capital loss	(\$200)

Item D(3)(c) excludes \$250 from the non assessable amount and item D(3)(d) excludes \$500 from the non assessable amount. No further reduction will take place under Item 7 as Delta has not obtained a Subdivision 152-C reduction in relation to the extra capital gain. Hence C2 reduces the cost base of Delta's units by \$250 being the non assessable amount.

**Example 5.2**

Assume the facts in *Example 2.2*. The comments made in relation the way in which the redraft would operate in *Example 4.2* would apply equally in this situation.

**Example 5.3**

Assume the facts in *Example 2.3*. The comments made in relation to the way in which the redraft would operate in *Example 4.3* would apply equally in this situation.

**Example 6**

Assume the facts in *Example 3* above. The suggested redraft would apply in that situation as follows:

***Alpha***

B(1)(a) inclusion = zero

B(1)(b)(i) inclusion = \$500

[representing the capital gain taken into account following step 4 in the method statement in s102-5(1).]

Taxable income from distribution      \$500

The combined operation of D2 and D3 will mean that the non assessable amount is \$500 being the excess of trust law income over net income that is attributable to Division 43 deductions. The cost base of the beneficiary's interest will be reduced by \$500.

***Beta***

B(1)(a) inclusion = zero

B(1)(b)(i) inclusion =	\$500 (as calculated for Alpha above)
Capital gain on other shares	\$400
Capital loss	(\$600)
B(1)(b)(i) inclusion after capital loss offset*	\$300
Taxable income from distribution	\$300

\* Assumption is made that beneficiary chooses to offset the capital loss against the undiscounted capital gain on the sale of other shares first. The balance of the capital loss is then set off against the extra capital gains on which a 50% discount is available.

The combined operation of D2 and D3 will mean that the non assessable amount is \$500 being the excess of trust law income over net income that is

attributable to Division 43 deductions. The cost base of the beneficiary's interest will be reduced by \$500.

### ***Gamma Pty Ltd***

Gamma Pty Ltd's position in this situation will be the same as Alpha's.

### ***Delta Pty Ltd***

B(1)(a) inclusion = zero

B(1)(b)(i) inclusion =	\$500 (as calculated for Alpha above)
Capital loss	(\$800)
Net capital loss	(\$300)

The combined operation of D2 and D3 will mean that the non assessable amount is \$500 being the excess of trust law income over net income that is attributable to Division 43 deductions. The cost base of the beneficiary's interest will be reduced by \$500.

## ***VII Assessment Of Redraft***

Although the suggested redraft is still complex, it is likely that it would be less legally and effectively complex than the present law. First, it contains a clear statement (accompanied by signposts to relevant operative provisions) of what the intended effect of the interaction of the provisions is. Secondly, it does not involve an inclusion of the s97(1) amount in the beneficiary's assessable income and its subsequent subtraction. This also means that it does not need to expressly negate the operation of s118-20. Thirdly, calculation of the extra capital gains is simplified in that, generally, it involves adding together each capital gain at the trust level and the general discounts and the small business discounts that were taken into account in calculating each trust capital gain. By contrast the current provision looks at each trust capital gain, asks what its component elements were and then grosses up the beneficiary's share of the trust capital gain by multiplying it by amounts which vary according to what the component elements of each trust capital gain were. Under the redraft some grossing up was found to be necessary in situations where losses and deductions at the trust level have reduced the beneficiary's share of the trust amount. Nonetheless, under the redraft the grossing up has been able to be confined to situations where it was strictly necessary. Fourthly, it imposes formal standardised obligations on trusts to advise beneficiaries of information that will be relevant to them in making necessary calculations under the provisions. Although many trusts already do this there is considerable variation between them in the nature and quality of information that they provide to beneficiaries. Fifthly in calculating the non assessable part of a distribution it positively states what is included and what is excluded and directs that amounts that are not actually paid to beneficiaries are subtracted. This is in contrast to the current provision which takes the amount of the distribution and then arrives at the non assessable part by excluding amounts even when those amounts do not form part of the actual distribution. Sixthly, the provisions dealing with this topic are also grouped together rather than located in different divisions of the ITAA. This is likely to mean that secondary explanatory

material such as *Taxpack* and practitioner texts can be simplified. Seventhly, the definition of the non assessable part is organised so that the provisions of less general application appear after the provisions of more general application.

Complexity is inevitable when income and tax preferences flow through an intermediate entity. Several discrete causes of complexity are operating in such situations and their effects multiply when they interact. Nonetheless redrafting of the provisions dealing with capital gains tax preferences flowing through trusts in a manner which makes the policy intent of provisions and their constituent elements and their relationship to other provisions more apparent, states general rules before stating rules which are only applicable to some taxpayers, and adopts a single perspective throughout could some remove some unnecessary complexity in their interaction. It is submitted that the redrafted provisions are less legally complex than the original provisions and also are likely to reduce the effective complexity of the system by facilitating the ability of taxpayers to locate aspects of the redrafted provisions which are relevant to them and by providing improved information to unit holders. In addition the heuristic value for tax professionals of working through an attempt to redraft complex provisions in an effort to reduce their complexity should not be underestimated.