

TAX BULLETIN

An update publication for our clients

7 June 2011

Changes to the Taxation of Trusts - Streaming capital gains and franked distributions for the year ending 30 June 2011

Overview

On 2 June 2011 the Assistant Treasurer introduced into Parliament a Bill ("the Bill") containing proposed changes to the taxation treatment of trusts for the 2010/11 year of income.

The two main proposed changes in the Bill aim to clarify: (i) the ability to stream dividends and franking credits; and (ii) that capital gains can be streamed for tax purposes. The proposed changes have been identified as "interim" measures to fix critical issues prior to the whole of the provisions being re-written into the 1997 Tax Act at a later date.

The Bill also contains a targeted integrity provision concerning distributions to exempt entities (e.g. charities).

There is a 'carve-out' in the Bill for managed investment trusts ("MITs") unless they elect into the regime within two months of year end. MITs that are wholesale funds and want to stream capital gains to redeeming unit holders may, following the *Colonial* case decision, wish to consider making such an election.

The Bill addresses many of the issues that we raised in our submission to Treasury on the earlier Exposure Draft ("ED") version that was issued in April. However, the provisions are highly prescriptive and can result in unintended outcomes if they are not applied correctly.

Furthermore, (in almost all cases) the provisions specifically require certain written records to be in place by 30 June 2011 in order to ensure tax effective streaming of the relevant amounts. Due to the highly complex nature of the provisions, we encourage you to discuss the application of these provisions with your Pitcher Partners representative before 30 June 2011 if you wish to stream capital gains or franked distributions through a trust.

ATO administrative treatment of the changes

While the proposed changes are intended to apply to the 2010/11 and later income years, as they are not certain to receive Royal Assent before 30 June 2011 the ATO has released details of its administrative treatment regarding the changes.

Trustee resolutions

The ATO has stated that in its view the changes will not allow for trustee resolutions made on or before 30 June 2011 to be amended - i.e. to take account of the law as finally enacted after that date. Therefore, in framing resolutions the ATO suggests that trustees should consider wording that is general enough to deal with the fact that the law may or may not be enacted as proposed.

Shortfall penalties and interest charges

The ATO has indicated that a taxpayer can choose to either apply the current law or anticipate the changes to the law. In either case, if there is an error made in the way that the law is applied, provided

the relevant taxpayer amends their return within a reasonable time the ATO will seek to remit shortfall penalties and provide reductions in the shortfall interest charges - either to nil or the base interest rate.

Critical issues for consideration by trustees by 30 June 2011

In light of the requirements of the Bill and the position of the ATO on amending trustee resolutions after 30 June 2011, there are three key considerations that will need to be addressed by trustees before 30 June 2011 if they wish to stream capital gains and/or franked distributions:

Firstly, under the Bill a trustee will only be able to stream a capital gain or a franked dividend to a beneficiary if the beneficiary is made "specifically entitled" to that capital gain and/or franked dividend. The proposed codification of the requirement to be "specifically entitled" to a particular streamed amount will mean that it will be critical for trustees to consider their relevant trust deeds before 30 June 2011 to determine whether it is possible to create such an entitlement.

In this regard, the Bill also requires the "specific entitlement" to be recorded in the accounts or records of the trust. These accounts/records need to be made by 30 June 2011 for franked dividends and by 31 August 2011 for capital gains.

Secondly, the explanatory memorandum ("EM") to the Bill requires a trustee to determine the capital gains and franked dividends available for streaming only after applying directly relevant expenses or losses. To satisfy this requirement, appropriate accounts (including schedules, calculations or notes) may need to be prepared by the trustee to identify the net franked dividend (i.e. after expenses) or capital gain (i.e. after losses) that is to be streamed and the specific allocation of that amount to beneficiaries.

Thirdly, a capital gain will only be streamed to the extent that the beneficiary has an entitlement to the gross capital gain (i.e. after the application of any losses but before the application of any concessions under the tax rules). For example, if a beneficiary is only entitled to \$50 out of a gross capital gain of \$100 (i.e. the discount component), the beneficiary can only be streamed 50% of the discounted capital gain (i.e. \$25). In order to distribute the whole of the taxable amount of \$50 to a beneficiary, the trustee would be required to distribute the non-discount component of the capital gain as well - i.e. make the beneficiary entitled to the whole capital gain of \$100.

Summary of the changes in the Bill

Here is a summary of the main changes contained in the Bill:

- where a beneficiary is specifically entitled to a capital gain included in the trust's taxable income, that beneficiary will be treated as having made a capital gain under the capital gains provisions and (unless they are entitled to other income from the trust) will not be assessed on any share of the trust's taxable income over and above the amounts assessed under the capital gains provisions;
- where a beneficiary is specifically entitled to a franked distribution, that beneficiary will be assessed under the imputation provisions on the amount of the franked distribution included in the taxable income of the trust estate and (unless they are entitled to other income from the trust) will not be assessed on any share of the trust's taxable income over and above the amounts assessed under the imputation provisions;
- where a beneficiary is entitled to other income from a trust in addition to a capital gain and/or a franked distribution, the amounts otherwise assessable to beneficiaries under the existing trust provisions in Division 6 of the 1936 Tax Act will be adjusted (by a proposed new Division 6E) to ensure that capital gains and franked distributions dealt with under the capital gains and imputation provisions are not taxed twice;

- an exempt entity will not be taken to be presently entitled to any amount of the trust's income unless they have either been paid or notified of their entitlement within two months of the end of the income year;
- if an exempt entity would otherwise be assessed on a disproportionate share of a trust's taxable income (i.e. relative to its actual entitlements to the income and/or capital of the trust), the trustee will be assessed on that amount unless the ATO decides that it would be unreasonable to do so.

How do the provisions work?

The Bill adopts the following “three step” process where capital gains and/or franked dividends are derived by a trust:

1. the trust provisions (i.e. Division 6) are to be applied as they currently do to determine the amount that a beneficiary would otherwise be taxable on. That is, a beneficiary will be (in the first instance) taxable on their share of all of the trust's taxable income based on their proportionate share to the total trust law income of the trust;
2. the capital gains and/or imputation provisions are then intended to operate to assess the beneficiary on their share of any capital gain made or franked distribution derived by the trustee. The share of these amounts will be determined by having regard to whether the beneficiary is specifically entitled to the relevant capital gain or franked distribution; and
3. finally, a new provision (to be contained in Division 6E of the 1936 Tax Act) will adjust the Step 1 amount to avoid double taxation.

Example demonstrating the proposed mechanics

The following example is used to demonstrate the intention of the new provisions. Assume a Trust derives:

- fully franked dividends of \$140 and has expenses directly related to the dividends of \$40 - i.e. has net cash dividend income of \$100 (plus \$60 of franking credits); and
- \$100 of business income after expenses.

If the trust deed defines income for the purposes of the Trust to mean income under ordinary principles, then the profit of the trust under trust law will equal \$200.

The net taxable dividend income of the Trust in this case will be \$160 (i.e. the net cash dividend of \$100 grossed up by \$60 of franking credits) and, assuming there are adjustments for timing differences such as accruals, the taxable business income is \$500.

The relevant trust law income and the net (taxable) income of the trust are shown in the following table.

Class of income	Trust law	Tax amount
Net cash dividends after expenses	\$100	\$100
Franking credits gross-up on the dividends	-	\$60

Class of income	Trust law	Tax amount
Net business income	\$100	\$500
Total income	\$200	\$660

If the trustee resolves to distribute all of the franked dividends to Beneficiary A and all of the business income to Beneficiary B, the three step process should provide for the following outcomes.

1. Under the current trust provisions Beneficiaries A and B would each have an entitlement to \$100 of trust law income - i.e. 50% each of the total trust law income. Under a proportionate approach, each beneficiary would be assessed on 50% of the total taxable income of \$660 (i.e. \$330 each). Each beneficiary would include a taxable grossed-up franked dividend of \$80 and taxable business income of \$250. Each beneficiary would also be entitled to a franking credit of \$30.
2. As Beneficiary A is specifically entitled to all of the franked dividends, Subdivision 207-B would include all of the \$160 net taxable dividend income in Beneficiary A's assessable income. Beneficiary A would therefore, also be entitled to a franking credit tax offset of \$60.
3. Division 6E would then apply to avoid double taxation. This provision should remove: (i) all of the income assessed to Beneficiary A under Step 1 (i.e. the whole of the \$330); and (ii) all of the dividend income assessed to Beneficiary B (i.e. \$80). Furthermore, Beneficiary B should be assessed on an additional \$250 of business income.

The result of the three steps should be that Beneficiary A will be taxable on \$160 - comprising the cash dividend of \$100 and the attached \$60 franking credit (on which Beneficiary A would also be entitled to a \$60 tax offset). Beneficiary B will then be assessed on \$500 - i.e. all of the taxable business income.

Beneficiary must be "specifically entitled" to a capital gain and/or a franked distribution

The amendments are designed to ensure that where a trustee has a power to stream income and gains under the terms of a trust deed, then that streaming will be effective for tax purposes. However, for the streaming of capital gains and franked distributions to be effective for tax purposes the beneficiaries must be "specifically entitled" to them.

To be specifically entitled a beneficiary must have:

1. received, or can be reasonably expected to receive, an amount equal to the net financial benefit referable to the capital gain and/or franked distribution derived by the trust; and
2. had their entitlement to the capital gain and/or franked distribution recorded as such in the accounts or records of the trust within the required time frames.

Capital gains and/or franked distributions to which no beneficiary is specifically entitled will flow proportionally to beneficiaries and/or the trustee based on their share of the income of the trust - i.e. excluding amounts to which any beneficiary is specifically entitled.

Meaning of "received or can be reasonably expected to receive"

A beneficiary must have received, or can reasonably be expected to receive, an amount equal to their "share of the net financial benefit" that is referable to the capital gain or franked distribution. According to the EM this does not require an "equitable tracing" to the actual trust proceeds from the event that

gave rise to a capital gain or the receipt of a franked distribution - instead, the entitlement can be expressed:

- as a share of the trust gain or distribution; or
- by a known formula even though the result of the formula is calculated later.

A beneficiary will 'receive' an amount when it has been: (i) credited or distributed to them; or (ii) paid or applied on their behalf or for their benefit.

A beneficiary 'can reasonably be expected to receive' an amount if the beneficiary has: (i) a present entitlement to the amount; (ii) a vested and indefeasible interest in trust property representing the amount; or (iii) an amount of the trust property set aside exclusively for them.

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

Meaning of net financial benefit

A net financial benefit is the 'financial benefit' or actual proceeds of the trust reduced by certain losses or expenses.

A 'financial benefit' is defined to mean anything of economic value (including property and services) - accordingly, it will include any accretion of value to the trust.

When determining a beneficiary's share of the net financial benefit referable to a "capital gain", the (gross) financial benefit referable to the gain is reduced by trust losses or expenses only to the extent that tax capital losses were applied in the same way.

When determining a beneficiary's share of the net financial benefit referable to a "franked distribution", the (gross) financial benefit is reduced by directly relevant expenses only.

Straddle contracts

Under the prior ED it was contentious as to whether a beneficiary could be made specifically entitled to a capital gain under a straddle contract - i.e. a contract for the sale of a CGT asset entered into before 30 June 2011 that settles some time after year end.

The EM states that provided (under the trust deed) a trustee resolves to distribute all of the trust profit on the sale of an asset to a beneficiary upon settlement, the beneficiary will be taken to satisfy the "can reasonably be expected to receive" test - the beneficiary will thus, be specifically entitled to the capital gain. Therefore, what is important in the case of a straddle contract is that the trust deed permits the trustee to make such a resolution.

Critical issues regarding: (i) accounting; and (ii) specific entitlements

In order for there to be an effective streaming for taxation purposes of any capital gain or franked distribution derived by a trust, a number of items must be complied with under the Bill in relation to the accounts and records of the trust.

- The amount (or fraction) of the net economic benefit that the beneficiary has received or can reasonably be expected to receive must be recorded in its character as a capital gain or franked distribution in the accounts or records of the trust. In this regard, the EM highlights that a written

trustee resolution in accordance with the trust deed will meet the definition of “records” for the purpose of the provisions. However, a record merely for tax purposes would not be sufficient.

- For capital gains, a beneficiary's entitlement must be recorded in the accounts or records of the trust no later than 2 months after the end of the income year. Accordingly, if a trustee resolution is to be used, this would need to be prepared in writing by 31 August 2011. (Note however, that as a trust deed may require the actual resolution decision to be made by the trustee by 30 June 2011, the additional two months may only provide an extension of time to document the meeting and decision made by 30 June 2011).
- For franked distributions, a beneficiary's entitlement must be recorded in the accounts or records of the trust by the end of the income year. Accordingly, if a trustee resolution is to be used, this would need to be prepared in writing by 30 June 2011.
- It will not be possible to stream tax amounts to beneficiaries where there is no net financial benefit remaining in the trust (for example, when a gross capital gain has been reduced to zero by losses).
- No beneficiary can be specifically entitled to a purely notional gain (for example, a deemed capital gain arising by application of the market value rules).
- It will not be possible to: (a) make a beneficiary specifically entitled to franking credits; or (b) separately stream franked distributions and franking credits.
- Specific entitlement to a capital gain or a franked distribution can be created through a chain of trusts by meeting the requirements for specific entitlement at each "step" in the chain.
- Where a beneficiary is entitled to unspecified amounts (such as "the balance of trust income" or "\$100 of trust income"), this will not be sufficient to create a specific entitlement. Therefore, the capital gains and franked dividends will flow to beneficiaries under the proportionate approach.

Managed Investment Trusts (“MITs”)

The Bill introduces a carve-out for MITs as defined in Division 275 of the 1997 Tax Act. Essentially, such trusts do not need to apply the amendments unless they make an election within two months of the 30 June 2011 or 30 June 2012 income year end. The carve-out has been specifically provided in anticipation of the MIT regime, which is scheduled to have effect from 1 July 2011.

While most retail MITs may not want to make an election to apply the new provisions, we highlight that wholesale funds may wish to consider the new provisions - especially where they have purported to stream significant capital gains to redeeming unit holders during the 30 June 2011 income year. That is, in January 2011, the Full Federal Court held in the decision of *Colonial First State Investments Ltd v FC of T* [2011] FCA 16 that such streaming was ineffective for tax purposes for the relevant wholesale trust under consideration. This was due to various issues including the fact that capital gains were not income of the trust under the relevant deed and the Court's view of the proportionate approach in accordance with the *Bamford* decision.

Under the Bill, it may be possible to overcome this issue and stream capital gains to the redeeming unit holders - i.e. provided the strict requirements of the Bill are otherwise satisfied.

Pitcher Partners is involved in the targeted consultation on the new MIT measures. If you have sought to stream capital gains during the year ending 30 June 2011, we would be happy to talk to you further about this issue.

Specific anti-avoidance rules

The Bill will introduce two specific anti-avoidance rules to prevent exempt beneficiaries being used to inappropriately reduce the amount of tax payable on the taxable income of a trust.

Under the first rule an exempt entity that has not been notified of its present entitlement to income of trust estate within two months of the end of the income year will be treated as if it was not presently entitled to that amount - i.e. the trustee will be liable to pay tax on the taxable income of the trust that relates to that present entitlement.

The second rule will apply where an exempt entity's share of the taxable income of a trust estate exceeds a prescribed benchmark percentage. This rule is aimed at preventing an exempt entity from receiving a disproportionate share of the trust's taxable income relative to the exempt entity's actual entitlement under the trust deed. For example, where an exempt entity receives 100% of the taxable income of a trust yet only receives 1% of the actual economic benefits of the trust (the prescribed benchmark percentage), the exempt entity will be treated as not being presently entitled to the "excess".

Concluding comments

The proposed changes to clarify the ability to stream capital gains and dividends are welcome and are broadly consistent with the submissions that have been made by Pitcher Partners.

We highlight that the proposed changes may have significant implications where a trust is seeking to stream either capital gains or franked dividends for the 30 June 2011 income year. Due to the highly complex nature of the provisions, we encourage you to discuss this with your Pitcher Partners representative before that date.

If a trust is seeking to stream other forms of income (foreign income, rental income etc), the ATO view is that streaming is ineffective for the purpose of these classes of income. Accordingly, great care needs to be taken where a trust is seeking to stream such other income.

Pitcher Partners will continue to make submissions on areas of concern that we have with the Bill. You are welcome to discuss any of your concerns with the Bill with a Pitcher Partners representative.

Further Information

Please ask either your regular Pitcher Partners tax contact or any of the contacts in the Pitcher Partners firms below for further details on the issues raised in this Tax Bulletin:

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