

TAX BULLETIN

AN UPDATE PUBLICATION
FOR OUR CLIENTS

15 April 2011

IMPROVING THE TAXATION OF TRUSTS

Overview

On 13 April 2011 the Assistant Treasurer released an Exposure Draft (“ED”) of proposed changes to the taxation treatment of trusts for the 2011 year of income. 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 two main proposed changes in the ED aim to clarify: (i) the ability to stream dividends and franking credits; and (ii) that capital gains can be streamed for tax purposes.

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

While the ED is still very much in draft form, we are pleased that the ED is broadly consistent with our submission to Treasury on 21 March 2011 on the earlier Discussion Paper on this topic.

A limited consultation period has been provided on the ED whereby submissions are due by 29 April 2011.

Critical issues for consideration by trustees

While the ED proposes amendments to support the ability to stream capital gains and dividends through trusts, we highlight three key components of the ED that will need to be considered by trustees wishing to stream such amounts.

Firstly, under the ED 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 dividend/gain. 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 to determine whether it is possible to create such an entitlement.

In this regard, the ED also requires the “specific entitlement” to be recorded in the accounts of the trust.

Secondly, the accompanying explanatory material makes it clear that a trustee will be required to determine the capital gains and dividends available for streaming only after applying directly relevant expenses. To satisfy this requirement, appropriate accounts may need to be prepared by the trustee to identify the net dividend or capital gain (i.e. after expenses) 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. 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.

Proposed mechanics

The ED proposes that the taxation of a trust's capital gains and franked distributions (including attached franking credits) will be removed from the existing provisions dealing with trust income (i.e. Division 6 of the 1936 Tax Act). Instead, specific provisions are to be inserted to deal with the taxation of capital gains (Subdivision 115-C) and franked distributions (Subdivision 207-B) that are derived by a trust.

In order to achieve this outcome, the following "three step" process is proposed by the ED.

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 net (taxable) income based on their proportionate share to the total trust law income of the trust.
2. The specific provisions mentioned above 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.
3. Finally, a new provision (to be contained in Division 5B of the 1936 Tax Act) will adjust the Step 1 amounts 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 (together with \$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 for 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.

TAX BULLETIN

Class of income	Trust law	Tax amount
Net cash dividends after expenses	\$100	\$100
Franking credit gross-up on the dividends	-	\$60
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 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 of \$60.
3. Division 5B 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. Beneficiary B will then be assessed on \$500 - i.e. all of the taxable business income.

Creating specific entitlements

The ED introduces a new concept, being “specific entitlement”. Streaming is proposed to be permitted only if a beneficiary is specifically entitled to the relevant amount. The ED currently proposes the following two rules for determining specific entitlement.

Capital gains	A beneficiary will be specifically entitled to a capital gain to the extent that: (i) in <u>accordance with the terms of the trust</u> the beneficiary has a vested and indefeasible interest in trust property representing the capital gain; and (ii) the vested and indefeasible interest is <u>recorded in the accounts of the trust estate</u> .
Franked distributions	A beneficiary of a trust is specifically entitled to a franked distribution made to the trust to the extent that: (i) in <u>accordance with the terms of the trust</u> the franked distribution has been specifically allocated, in its character as a franked distribution, to the beneficiary; and (ii) the specific allocation is <u>recorded in the accounts of the trust</u> .

We highlight that neither rule currently provides a timing requirement - that is, the ED does not clarify when the specific entitlement must be created. Assuming that such entitlements must be created at or before 30 June, we highlight that the current ED clearly requires regard to be had to the terms of the relevant deed. This raises a number of important issues to consider including:

- Whether the capital gain is treated as income or capital of the trust under the deed. The income and capital distribution clauses of trust deeds are not always the same and therefore, may (or may not) permit an entitlement to an amount before year end.
- Where a capital gains tax event occurs before year end but the transaction settles after year end, a trustee will need to consider whether (under the terms of the trust deed) a specific entitlement can be created to the capital gain before year end - i.e. before settlement occurs. Taking into account the dot point above, the result may be different depending on whether the capital gain is treated as income or capital under the deed.
- Where a discount capital gain is derived, a deed that equates trust law income to trust net (taxable) income would arguably bifurcate a discount capital gain into two components, being income (the 50% taxable component) and capital (the 50% non-taxable component). Proper regard would need to be had to the trust deed to ensure that appropriate distributions are made to the whole of the gross capital gain to ensure the desired streaming is effective.
- Where dividends are to be streamed, regard needs to be had to the trust deed to ensure that streaming is not precluded and that dividend income can be streamed to a particular beneficiary.
- The accounts will need to reflect the specific entitlements to the various capital gain and dividend classes in order for streaming to be effective.

Specific anti-avoidance rules

The ED also proposes specific anti-avoidance rules to prevent the use of exempt entities to 'shelter' taxable income of a trust. These provisions will apply in two circumstances.

- The first circumstance is where an exempt entity is not paid its distribution within two months after the end of the income year. In this case, the trustee will be assessed on the distribution. There appears to be no ATO discretion in this case to avoid this outcome.
- The second circumstance is where an exempt entity would otherwise be assessed on a disproportionate share of a trust's net (taxable) income - i.e. relative to its actual entitlements to the income and/or capital of the trust. In this case the trustee will be assessed on that amount unless the ATO decides that it would be unreasonable to do so.

Where trusts make legitimate distributions to charities care will need to be taken to ensure compliance with these provisions.

Concluding comments

The proposed changes to clarify the ability to stream capital gains and dividends are welcome and are broadly consistent with the submission that was 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 dividends for the 30 June 2011 income year. 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 purposes 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 be making a submission on these issues by 29 April 2011. You are welcome to discuss any of your concerns with these proposed amendments 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:

- John Brazzale (Melbourne), Partner. Tel: 03 8610 5110 Email: john.brazzale@pitcher.com.au
- Alexis Kokkinos (Melbourne), Partner. Tel: 03 8610 5170 Email: alexis.kokkinos@pitcher.com.au
- Chris Ardagna (Sydney), Partner. Tel: 02 9220 9156 Email: cardagna@pitcher-nsw.com.au
- Julie Strack (Perth), Partner. Tel: 08 9322 2022 Email: strackj@pitcher-wa.com.au
- Richard Brooks (Adelaide), Partner. Tel: 08 8179 2860 Email: richard.brooks@pitcher-sa.com.au
- Chris Ball (Brisbane), Partner. Tel 07 3222 8444 Email: cball@jr.com.au

DISCLAIMER: Pitcher Partners is an association of independent firms. This bulletin is intended to provide a general summary only and should not be relied on as a substitute for professional advice.
--