

TAX BULLETIN

AN UPDATE PUBLICATION
FOR OUR CLIENTS

21 January 2011

FURTHER UNCERTAINTY RELATING TO THE TAXATION OF TRUSTS

Executive summary

A recent Federal Court case has created further uncertainty regarding the taxation of trusts and has once again highlighted the need for legislative reform in this area.

It had been anticipated that the case would provide some guidance and certainty on the application of the taxation provisions relating to the streaming of income and, in particular, capital gains.

Unfortunately, the decision provides little by way of guidance and further highlights the uncertainty and ambiguity of the application of the trust taxation provisions.

The case also implies that almost all Managed Investment Trusts (“MITs”) will not be fixed trusts for tax purposes.

It is to be hoped that the legislative reviews that are currently in process will help to correct these issues and provide further certainty to taxpayers.

The implications of this case will depend on whether the case is appealed by the taxpayer. Where there is an appeal, there will be a significant level of uncertainty as the case makes its way through the appeal courts. If the case is not appealed, we will be encouraging the ATO to release a Decision impact statement outlining its views on what the case means.

In the interim, managed funds (and trusts generally) should be examining their trust deeds to determine whether any of the issues raised in this case could have implications for them. Furthermore, funds/trusts should be considering whether the potential taxation problems highlighted by this case can be addressed by possible amendments to their deeds (and what resettlement implications may flow from these proposed amendments). Finally, we would encourage managed funds and other trusts to be involved in the consultation process on the review of trusts to ensure that legislative amendments are put in place to create certainty in the tax laws.

Background

On 18 January 2011 the Federal Court (Stone J) handed down its decision in relation to the long awaited trust case of *Colonial First State Investment Limited v Commissioner of Taxation* [2011] FCA 16. The case involves many issues relating to the operation of the trust provisions - in particular, those relating to the treatment of capital gains and the ability to stream such gains.

Facts of the case

The case dealt with an application for a private ruling by Colonial First State Investment Limited (“Colonial”) as trustee for a retail unit trust investment fund (“the Retail fund”) which held units in another unit trust fund (“the Wholesale fund”).

The private ruling sought was in relation to the operation of the trust taxation provisions on the redemption of units in the Wholesale fund. In particular, the Wholesale fund sought to amend its constitution so that the proceeds of the redemption could include various components - including an amount of trust capital (or ‘corpus’) and an income amount. The income amount would comprise amounts taken from either: (i) a short term capital gain reserve; or (ii) a long term capital gain reserve (collectively referred to as the “Gain part”).



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The purpose of the amendments was two fold. Firstly, the Wholesale fund sought to stream appropriate capital gains to unit holders based on their characteristics (e.g. amounts from the long term capital gain reserve would be distributed to long term unitholders). Secondly, where a unitholder redeemed its units during the year and the unit value represented undistributed income, the fund sought to provide a distribution of income to the unitholder (whereby the redemption proceeds would be reduced by that amount).

Colonial stated that both of these amendments would provide for a fair allocation of amounts amongst the beneficiaries. The private ruling requested that the Commissioner provide his opinion on the efficacy of the proposed amendments - in particular, in allowing income (and thus capital gains) to be distributed to the redeeming unitholders. The private ruling also requested the Commissioner's view as to whether the trust was a fixed trust for tax purposes.

Decision of the Court

Summary

In short, the Court held that the redeeming unitholders would not be entitled to the income of the trust and would be taxable on the whole redemption proceeds under the capital gains provisions. Either the remaining unitholders or the trustee would also be taxable on the income of the trust. Effectively, this answer provides for an unfair result for beneficiaries, as there is an effective double taxation of the same gain to two different taxpayers.

The court also held the trust was not a fixed trust.

On the unfairness point, the Court made the important observation (at the outset) that the operation of the trust taxation provisions can readily produce unfair outcomes.

In some parts of the case it would seem clear that the wording of the deed in question produced anomalies and that a different outcome may have been achieved if the wording had been different. As the Court did not comment on any alternative wording, the decision creates a number of new uncertainties in relation to the treatment of the income of a trust - in particular, when there is a redemption of units by a unit trust.

Using a custodian does not prevent a unitholder being a beneficiary

The first issue considered by the Court was whether the Retail fund was a beneficiary of the Wholesale fund or whether the units were vested in a custodian - who held the units pursuant to the Managed Investment Scheme ("MIS") rules in the Corporations Act. The ATO argued that the custodian relationship created another trust relationship for tax purposes (a sub-trust), so that the Retail fund was merely a beneficiary of the sub-trust and not a beneficiary of the Wholesale fund.

Critically, the Court rejected the ATO's argument and held that the Retail fund would be a beneficiary of the Wholesale fund. This aspect of the decision is important, due to recent concerns that the ATO would seek to apply the trust taxation provisions to each and every trust relationship that is identified. Accordingly, the Court has provided some comfort that trust taxation does not need to be applied in respect of the custodian relationship and the assets held by the custodian.

Capital gain reserves and income of the trust

The Court considered whether the capital gains derived by the Wholesale fund were income of the trust, to which the answer was 'No'. The Court distinguished the case from the facts in the *Bamford* and *Cajkusic* decisions - where the relevant trust deeds provided the trustees with an ability to determine whether amounts would be either capital or income.

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The Court held that the relevant clauses of the Wholesale fund deed did not allow such a characterisation and accordingly, the capital gains would not be income of the trust. This decision highlights how critical it is to properly understand the deed and the possible ramifications for deeds that are not drafted appropriately. (As an aside, it is interesting to note that the Court did not consider that the “short term” capital gains could be ordinary income of the trust - even though the ATO has contended this point for some time and is expected to release a tax ruling on this issue in early 2011).

Present entitlement to income

The Court then considered whether a redeeming unit holder could be presently entitled to an amount of income, being an amount from the various capital gain reserves. The answer to this question was ‘No’. The proposed drafting of the deed required the source of the redemption amount to be determined after the end of the financial year during which the entitlement arose - the Court held that it was only at this time (i.e. after the end of the relevant tax year) that the capital gain could have been included in the income of the trust. As this would be in a different year to the tax year in which the redemption occurred, the unitholder could not be presently entitled to the amount in the relevant year of redemption.

It would seem however, that this conclusion may be limited to the facts of the case. That is, the deed was drafted such that an appropriation could only be determined in the following year. Furthermore, it is also implicit that this decision is based on the fact that the capital gain was not income of the trust in that year of income (unlike in the case of *Bamford*). Accordingly, the Court may have come to a different conclusion if capital gains could be determined to be income at a time prior to year end - i.e. so that a beneficiary could be made presently entitled to that amount prior to year end.

Amount of the net income

Assuming the beneficiaries were presently entitled to income, the Court then considered the amount of net income (or taxable income) that the beneficiaries would be entitled to. It seems that Colonial contended that the Gain part should be the same as the amount included in the assessable income of the trust (and thus, be the same as the amount attributed to the beneficiaries). The Court rejected this view.

In applying the decision in *Bamford*, the Court stated that the Gain part was calculated as an ‘amount’. This amount would be compared to the total income of the trust to yield a proportion. This proportion would then determine the amount of the net income attributed to the beneficiary. The amount of the net capital gain attributed would therefore, be based on that ratio.

Whilst the Court did not go on to discuss the ramifications of this conclusion, the decision provides some uncertainty as to the ability to stream capital gains to beneficiaries. We understand that the ATO will issue rulings on their view of this area in early 2011.

Taxation of the unitholders who do not redeem their units (the “remaining beneficiaries”)

Colonial sought to determine how the remaining beneficiaries would be taxable on their share of the net income that had not been distributed to the redeeming unitholders. Unfortunately, it is (simply) unclear whether the Court concludes that the remaining beneficiaries or the trustee should be taxed on this share.

As we believe that a number of other unit trusts and managed funds have trust deeds that are worded in a similar manner to the deed considered in this case, it will be crucial for any ATO Decision impact statement that is issued to provide certainty on this particular aspect.



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Redemption proceeds

Colonial sought clarification as to the correct treatment of the redemption proceeds to the redeeming unitholders. The Court concluded that the whole amount that exceeded the subscription price was to be treated as a capital gain under CGT event C2. As this excess amount also represented the Gain part, which would be taxable to the other beneficiaries (or the trustee in a worst case scenario), this conclusion would result in two taxpayers paying tax on the same underlying gain.

Fixed trust

The Court also considered whether the Wholesale fund was a fixed trust. A number of provisions (e.g. trust losses and the flow through of imputation credits) operate differently where a trust is not considered a fixed trust. In this case, the responsible entity in question was subject to the Corporations Act requirements of section 601GC - where the trust deed can only be amended if it does not adversely affect member's rights.

The Court held that while this restriction means that the overall entitlement of a beneficiary cannot change, the fixed trust requirement looked at whether a "vested and indefeasible" interest existed in the income and capital. While a change in capital or income rights may not change the overall entitlement of a beneficiary, such a change could still mean that the beneficiary did not have a "vested and indefeasible" interest in either the income or capital. The Court therefore, held that the trust would not be a fixed trust.

It is noted that there is a Commissioner's discretion to treat a fund as a fixed trust. However, the case does not examine this discretion. For registered funds, this decision creates a high degree of uncertainty on whether such funds will be fixed trusts. If this decision stands, this may result in enormous pressure being placed on the ATO to exercise its discretion and significant uncertainty in relation to such funds for prior years.

Legislative corrections

As outlined earlier, some aspects of the case are likely to be limited to the facts of the case. Due to the particular drafting of the deed, some of the issues raised may not occur where deeds are drafted in a different manner. However, as the case does not discuss these differences there will be some degree of uncertainty on these issues until there is either legislative amendment or guidance provided by the ATO.

It is important to note that there are currently two legislative processes examining trust taxation that may help to provide some clarification on these issues.

In October 2010, the Treasury released a discussion paper dealing with the taxation regime for managed investment trusts. The paper proposes a new "attribution" method for allocating net income to beneficiaries on a "fair and reasonable" basis. The Treasury discussion paper proposes a treatment that would be consistent with (or in line with) the method proposed by Colonial on a redemption.

Furthermore, the paper proposes that certain MITs that meet the Corporations Act requirements of section 601GC be deemed to be fixed trusts. It is noted that these amendments are proposed to apply from 1 July 2011 and will not apply retrospectively. Furthermore, these amendments will not apply to all managed funds - only those that have "clearly defined rights".

For trusts other than managed funds, on 16 December 2010 the Assistant Treasurer announced a review of wider trust issues. Hopefully, this process will also help to clarify many of the issues covered in this case.



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FURTHER INFORMATION

In Victoria, the Pitcher Partners representatives named below can be contacted for further details on the issues raised in this Tax Bulletin. In all other states please contact your regular Pitcher Partners tax contact in any member firm.

Melbourne

Alexis Kokkinos
Partner – Tax Consulting
alexis.kokkinos@pitcher.com.au
+61 3 8610 5170

Brendan Britten
Partner – Business Advisory & Assurance
brendan.britten@pitcher.com.au
+61 3 8610 5279

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Melbourne

Telephone +61 3 8610 5000
partners@pitcher.com.au

Sydney

Telephone +61 2 9221 2099
partners@pitcher-nsw.com.au

Perth

Telephone +61 8 9322 2022
partners@pitcher-wa.com.au

Adelaide

Telephone +61 8 8179 2800
partners@pitcher-sa.com.au

Brisbane

Telephone +61 7 3220 0355
partners@pitcher-qld.com.au

