

March 2011 Tax Newsletter

TAXATION OF TRUSTS

The purpose of this tax newsletter is to discuss practical aspects of the taxation of trusts having regard to recent developments.

1. Streaming of income and claiming of CGT concessions

The High Court decision in *Commissioner of Taxation v Bamford* (2010) HCA 10 (“*Bamford*”) determined that the phrase “income of the trust estate” in subsection 97(1) of the *Income Tax Assessment Act 1936* (“*Tax Act 1936*”) was determined by the general law of trusts and, therefore, the trust deed could determine what is “income” for that purpose. Further, the High Court determined that what is included in a beneficiary’s assessable income is the beneficiary’s proportion of the net income of the trust (as defined in subsection 95(1) of the *Tax Act 1936*) as determined by the beneficiary’s entitlement to “income of the trust estate”.

The first practical point that came out of *Bamford* is the need to review trust deeds and, in particular, the relevant definition of “income” (see also the recent decision in *Colonial First State Investments Pty Limited v FC of T* (2011) FCA 16). Many older deeds do not define “income” for the purposes of the trust deed which means a capital gain represents “capital” of the trust. The distribution of a capital gain under those deeds can only be made as a distribution of capital, with the possibility that the beneficiaries entitled to “income” of the trust are assessed on the net capital gain though they have no entitlement to that capital gain.

The second practical point that came out of *Bamford* is the casting of some doubt as to whether the trustee of a trust can stream income having a certain characteristic to one or more beneficiaries to the exclusion of other beneficiaries. When the Australian Taxation

Office (“ATO”) released its Decision Impact Statement on *Bamford*, it announced the proposed withdrawal of Taxation Ruling TR 92/13 which contained a number of critical propositions required for streaming of income to take place.

On 4 March 2011, the Assistant Treasurer announced the Government had decided to amend the tax law to ensure that capital gains and franked dividends (including the attached franking credits) can be streamed to one or more beneficiaries to the exclusion of other beneficiaries. The proposed amendments are to apply for the year ended 30 June 2011. Thus, the uncertainty as to streaming of capital gains and dividends no longer exists.

However, the trustee of a trust must still have power under the trust deed to stream income or capital having a certain tax attribute. If streaming of capital gains or dividend income is desired for the year ended 30 June 2011, the trust deed should be checked to ensure that such streaming provisions exist and, if they do not exist, the trust deed should be amended.

It should also be noted that the ability to stream a capital gain to a particular beneficiary can be important to access:

- the 50% exemption under Division 115 of the *Income Tax Assessment Act 1997* (“*Tax Act 1997*”);
- one or more of the “small business capital gains tax (“CGT”) concessions” under Division 152 of the *Tax Act 1997*.

Particular issues arise where the trust does not have “income” for the purposes of the trust deed either because the trustee does not derive other types of income or because of the claiming of the various CGT concessions at the trust level (so there is no “net income” for subsection 95(1) of

the *Tax Act 1936* purposes). Where the trustee of a trust has derived a capital gain, considerable care needs to be taken in drafting the memorandum of resolutions of directors of the trustee of the trust to ensure the trustee of the trust can claim one or more of the CGT concessions.

2. Amendment of trust deed

It can be seen from the above that it may be desirable to amend the trust deed. The question arises whether the amendment of the trust deed causes a CGT or a stamp duty liability.

A CGT liability potentially arises if the effect of the amendment is to create a new trust (CGT event E1: subsection 104-55(1) of the *Tax Act 1997*). The ATO's views as to when a new trust is created are found in a document titled "Creation of a New Trust – Statement of Principles" ("Statement of Principles").

In *C of T v Commercial Nominees of Australia Limited* (2001) 75 ALJR 442 ("*Commercial Nominees*"), the High Court held that major changes to a superannuation trust deed and the change in design of the superannuation fund in question did not amount to the creation of a new superannuation fund. The Statement of Principles sought to confine *Commercial Nominees* to changes made to superannuation funds. This narrow view of *Commercial Nominees* was recently rejected by the Full Federal Court in *Commissioner of Taxation v Clark* (2011) FCAFC 5 ("*Clark*") which applied *Commercial Nominees* in a general trust context.

From a practical point of view, *Clark* gives comfort that quite extensive amendments can be made to a trust deed without causing a new trust to come into existence and, therefore, no potential CGT liability (though it should be noted that the Commissioner is seeking special leave in *Clark* to appeal to the High Court).

From a NSW stamp duty point of view, no stamp duty liability should arise even if the property in the trust is "dutiabie property". This is on the basis the deed of amendment does not create a new trust.

3. The issue of unpaid present entitlements

An unpaid present entitlement ("UPE") arises where a beneficiary is presently entitled to income of a trust but has not been paid that entitlement.

The beneficiary has the right to request payment of its entitlement to income at any time, with the beneficiary being assessed on his/her/its share of the income of the trust in accordance to his/her/its entitlement to income of the trust.

In the January 2010 newsletter, I dealt with the ATO's views as expressed in Draft Taxation Ruling TR 2009/D8. That Ruling was finalised on 2 June 2010 as Taxation Ruling TR 2010/3 ("Taxation Ruling"). Practice Statement Law Administration PS LA 2010/4 ("Practice Statement") outlines how the ATO is to administer the Taxation Ruling.

No issue arises where an individual beneficiary or the trustee of a trust has an unpaid UPE. Rather, the issue arises where a corporate beneficiary of a trust has a UPE and, in particular, the application of Division 7A of the *Tax Act 1936* to that UPE. If the accounts of the trust and the corporate beneficiary record the UPE as a loan, there is some basis for stating that there is a loan by the corporate beneficiary to the trustee of the trust representing the UPE and that Division 7A of the *Tax Act 1936* applies to that loan. This is the position taken by the ATO in paragraph 74 of the Taxation Ruling.

Therefore, from a practical point of view, care should be taken not to describe the UPE of a corporate beneficiary as a loan liability in the trust accounts or as a loan receivable in the corporate beneficiary's accounts.

The more contentious issue is where a corporate beneficiary has a UPE which is not described as a loan and is simply used by the trustee of the trust as working capital. The ATO takes the view that where the corporate beneficiary has knowledge that the funds representing its UPE are being used by the trustee of a trust for trust purposes, the corporate beneficiary in not calling for payment of the UPE is providing the trustee with "financial accommodation" and, therefore, Division 7A of the *Tax Act 1936* applies (paragraph 23 of the Taxation Ruling).

As a matter of legal analysis, and having regard to the purpose of Division 7A of the *Tax Act 1936*, there is considerable doubt whether a corporate beneficiary provides "financial accommodation" by simply not demanding payment of its UPE from the trustee of the trust. It

is expected that a future test case will resolve the issue.

In terms of the Taxation Ruling, no Division 7A of the *Tax Act 1936* problem arises as to UPEs used for working capital of the trust where the UPE of the corporate beneficiary arises before 16 December 2009 (paragraph 28 of the Taxation Ruling). In practical terms, UPEs of corporate beneficiaries for the year ended 30 June 2009 and prior years of income are “grandfathered”.

Further, a UPE of a corporate beneficiary that arises in the year ended 30 June 2010 does not cause a Division 7A of the *Tax Act 1936* liability for that year of income. This is because the ATO takes the view that the “financial accommodation” only arises during the income year following that in which the UPE is taken to have arisen for tax purposes (paragraph 112 of the Taxation Ruling). Thus, a potential Division 7A of the *Tax Act 1936* problem arises for a 30 June 2010 UPE in the year ended 30 June 2011.

The quantum of the UPE is an amount determined in accordance with the trust deed. If an amount represents capital for trust law purposes and is income for tax law purposes (e.g. a deemed dividend on liquidation), there may be an advantage in defining income in the deed in terms of trust law concepts rather than tax law concepts so as to reduce the quantum of the UPE potentially subject, in terms of the Taxation Ruling, to Division 7A of the *Tax Act 1936*.

In relation to a 30 June 2010 UPE, in the year ended 30 June 2011 there are a number of options (in terms of the Taxation Ruling) to avoid the Division 7A of the *Tax Act 1936* problem. Those options are:

- (a) pay the UPE on or before 30 June 2011;
- (b) trustee of the trust and the corporate beneficiary enter into a Section 109N of the *Tax Act 1936* complying loan on or before the due date for lodgment of the trust’s income tax return for the year ended 30 June 2011;
- (c) a “sub trust” relationship is entered into on or before 30 June 2011.

On its face, the option in paragraph (a) may not appear attractive. However, with careful planning, the Division 7A of the *Tax Act 1936* (in terms of

the Taxation Ruling) liability can be potentially deferred for up to 4 years with the trustee of the trust retaining the amount representing the UPE as working capital.

The option outlined in paragraph (b) is the normal exclusion applying to a loan made by a private company to a person who is either a shareholder of that company or an associate of the shareholder. Though the payment of interest is not an issue since the interest is likely to be an allowable deduction in calculating the net income of the trust and assessable to the corporate beneficiary, the practical problem is the need to pay back the principal of the loan at the end of the 7 years period (assuming unsecured).

The sub trust option in paragraph (c) is divided into 3 investment options outlined in paragraph 63 onwards of the Practice Statement. The 3 options are:

- option 1: invest the funds representing the UPE on an interest only 7 year loan;
- option 2: invest the funds representing the UPE on an interest only 10 year loan;
- option 3: invest the funds representing the UPE in a specific income producing asset or investment.

Again, the problem with options 1 and 2 is the ability of the trustee of the trust to repay the principal in the 7 year or 10 year period. The problem with option 3 is that the relevant asset held by the trustee of the trust is held on a sub trust for the corporate beneficiary which, from a practical point of view, means that if the asset is sold, the 50% exemption under Division 115 of the *Tax Act 1936* is unlikely to be able to be claimed.

It should be apparent from the above that, more than ever, careful attention has to be made to the terms of trust deeds and the terms of the resolutions of directors of the trustee as to the making of trust distributions.

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