

Eleventh hour trust changes

Our recent article on year-end tax planning addressed pre-30 June housekeeping matters in relation to discretionary trusts and included comment in relation to documenting your trustee resolution in accordance with the terms of the trust deed, including where the trust deed permits the distribution of separate classes of income such as capital gains and fully franked dividends.

Last week a bill concerning the taxation of trusts passed through both houses of Parliament and upon receiving Royal assent will become law with effect from 1 July 2010.

As a minimum this bill will have at least a technical impact upon the taxation treatment applicable to discretionary trusts with capital gains and franked dividends and, in some cases, may have a practical impact on the taxation outcomes. This may necessitate more careful drafting of trustee resolutions.

As well as discussing these changes, this article will also discuss the specific anti-avoidance rules being introduced by the same bill with respect to the use of exempt beneficiaries.

Capital gains and franked distributions

After the decision of the High Court in *Bamford's* case last year, the Commissioner raised various concerns about the taxation of trusts including in relation to the ability of trustees to distribute capital gains as income of a trust or to stream different classes of income to different beneficiaries as is permitted by many discretionary trust deeds. Among other things the Commissioner withdrew a practice statement concerning the manner in which he would administer the treatment of capital gains distributed by trustees and last week withdrew his 1992 ruling on the distribution by trustees of dividend income.

In March this year the Government announced, among other things, that it would legislate to ensure that trusts would continue to be able to stream capital gains and franked dividends where the relevant deed permitted. Tax Laws Amendment (2011 Measures No. 5) Bill, which passed through Parliament last week, was recently introduced as an interim measure to fulfil this commitment. Other problems and uncertainties concerning the taxation of trusts are to be addressed by Government later as part of an update and rewrite of the trust income tax provisions.

What are the changes?

In broad terms, where a trust has capital gains or franked dividends and a beneficiary is given a "specific entitlement" (a newly introduced concept) to either or both of these categories of income then those amounts are effectively taxed outside of the existing trust taxation provisions. Note that it is not possible to separately stream franking credits only (that is, without the relevant dividend).

Remaining amounts will continue to be taxed under the existing trust taxation provisions. Note that the Commissioner will want those remaining amounts treated as distributed on a proportionate basis to beneficiaries so that, for example, a beneficiary in receipt of half the remaining income will receive half of each class of remaining income.

For trusts without capital gains or franked distributions (or trusts which do not permit the streaming of different classes of income) the streaming changes will have no effect.

How to make a beneficiary “specifically entitled”

In order for a beneficiary to be specifically entitled to a capital gain or a franked distribution in a way that will be effective for tax purposes:

- The beneficiary must receive, or be reasonably expected to receive, an amount equal to the “net financial benefit” referable to the capital gain or franked distribution in the trust; and
- The entitlement must be recorded in its character as such in the accounts or records of the trust (which include the trust deed itself and distribution statements and schedules or notes intended to be read with them).

A “net financial benefit” is the “financial benefit” (anything of economic value) or actual proceeds of the trust (however characterised) reduced by certain trust losses or expenses so that:

- When calculating the net financial benefit referable to a capital gain you can only reduce the gross financial benefit referable to the gain by trust losses or expenses to the extent that tax capital losses were applied in the same way; and
- When determining the net financial benefit referable to a franked distribution, the gross financial benefit is reduced by directly relevant expenses only (such as appropriately allocated interest expenses or fees paid for management of a share portfolio). Note that you cannot make someone specifically entitled to a zero amount, for example, if you had a negatively geared share portfolio because interest deductions relevant to the shares exceeded the amount of the dividends.

The Explanatory Memorandum to the Bill states that the following resolutions or trust entitlements would satisfy the requirement of being “recorded in its character as referable”:

- Under the trust deed a beneficiary is entitled to all of the capital gains of the trust;
- The trustee resolves to distribute all of the dividends of the trust to a beneficiary;
- Under a trust deed that includes capital gains as income (either by default or because the trustee exercises a power to re-characterise the amount as income) a beneficiary is entitled to all of the profits made on or derived from an asset;
- Under a trust deed that does not include capital gains as income, the trustee resolves to advance capital representing profits from the sale of a property equally to the beneficiaries.

By way of contrast, the Explanatory Memorandum goes on to say that where a beneficiary is entitled to unspecified amounts (or shares) – such as “the balance of trust income”, “all of the trust income”, “half of the trust income” or “\$100 of trust income” – this is not sufficient to create a specific entitlement because the entitlements have not been recorded *in their character* as referable to a capital gain or franked distribution. This is the case even if the beneficiary’s entitlement contains amounts referable to capital gains or franked distributions and even if the beneficiary’s entire entitlement is referable to capital gains and/or franked distributions.

The legislation provides that for capital gains, a beneficiary’s entitlement must be recorded no later than two months after the end of the income year and for franked distributions, a beneficiary’s entitlement must be recorded by the end of the income year.

A fax received from the ATO this morning (29 June) announces that the Commissioner will put in place two administrative arrangements:

- The first will extend the time for trustees to record a beneficiary's entitlement to a franked distribution;
- The second is that they will not select cases for review of audit in respect of the 2010-2011 year for the sole purpose of determining whether the purported streaming of capital gains or franked distributions by a trustee is tax effective.

The ATO will make more information on these arrangements, including the new timeframes, available on their website from tomorrow afternoon.

Trustees should not take too much comfort from legislative or administrative timeframes for recording a beneficiary's entitlement as the trust deed will almost invariably require that the trustee's decision has been made by 30 June (in some cases earlier).

Trustee resolutions

In our recent article on year-end tax planning the final point we made with respect to pre-30 June housekeeping for discretionary trust distributions was as follows:

- Document your resolution in accordance with the terms of the trust deed. For example, if income in accordance with the trust deed is based on net income for tax purposes and permits the distribution of separate classes of income (of which there also includes capital gains and fully franked dividends) a resolution may run along lines such as the following (in all cases tailored to the particular circumstances including tax attributes of beneficiaries):

"The trustee has considered all the beneficiaries of the trust and, in accordance with the terms of the trust, resolves to distribute the income of the trust as follows:

1. All capital gains are distributed to Adult Individual A;
2. All dividends are distributed to Company X;
3. The remaining income of the trust is distributed as follows:
 - i. The first \$3,333 to Minor Individual B;
 - ii. The next \$3,333 to Minor Individual C;
 - iii. The next \$80,000 to Adult Individual D;
 - iv. The balance to Company X"

The good news is that a resolution such as this should meet the requirements for making Adult Individual A specifically entitled to the capital gains and Company X specifically entitled to the franked dividends.

If there are any unfranked dividends, however, then on the Commissioner's view that streaming of tax characteristics is impermissible other than in accordance with this new legislation, then whilst the Company will receive the amount of unfranked dividends as per the trustee's resolution, the tax characteristics of the amount will be a blend of the unfranked dividends and the remaining income of the trust and similarly, the amount distributed as "the remaining income of the trust" will, for tax purposes, include a blend of unfranked dividends and the remaining income of the trust.

This has the potential to give less efficient tax outcomes than if streaming of all individual classes of income can occur. For example, income on which foreign taxes have been paid is often not distributed to a company because the foreign taxes do not give rise to imputation credits with which the company can later frank a dividend whereas an individual receiving such income would generally receive a direct tax offset for the foreign taxes paid.

Accordingly, the effective outcome of the above resolution if there are franked dividends is, on the Commissioner's view, equivalent to:

"The trustee has considered all the beneficiaries of the trust and, in accordance with the terms of the trust, resolves to distribute the income of the trust as follows:

1. All capital gains are distributed to Adult Individual A;
2. All franked dividends are distributed to Company X;
3. The remaining income of the trust is distributed as follows:
 - i. All unfranked dividends are distributed to Company X;
 - ii. The next \$3,333 to Minor Individual B;
 - iii. The next \$3,333 to Minor Individual C;
 - iv. The next \$80,000 to Adult Individual D;
 - v. The balance to Company X"

Remember, the important thing for trustees is to ensure that they have made their beneficiaries specifically entitled (by use of appropriate language in resolutions - such as reproduced from the Explanatory Memorandum) to capital gains and franked dividends unless they are happy for all beneficiaries to take a proportional entitlement to the capital gains and franked dividends (noting, for example, that if a company beneficiary was being used, a trustee would not ordinarily want a company to receive a share of discount capital gains or other concessionally taxed capital gains).

Exempt beneficiary anti-avoidance rules

To prevent exempt beneficiaries being used to inappropriately reduce the amount of tax payable on the taxable income of a trust (not being a managed investment trust) two anti-avoidance rules have been introduced:

- First, an exempt entity that has not been either notified in writing or paid their entire present entitlement to income of the trust estate within two months of the end of the income year will not be treated as presently entitled to that amount and the trustee will be liable to pay tax on the relevant taxable income (subject to the possible application of a Commissioner's discretion). Such an outcome will give rise to a pure economic loss so these timing requirements should be strictly adhered to; and
- Second, where an exempt entity's adjusted share of the income of the trust estate exceeds a prescribed benchmark percentage (that is, it receives a disproportionate amount of the trust's taxable income relative to its actual entitlements from the trust), the exempt entity is treated as not being presently entitled to the "excess" and the trustee will be liable to pay tax on the relevant taxable income (again subject to the possible application of a Commissioner's discretion).