

New Rules for Trust Distributions

The Government has released exposure draft legislation containing provisional measures to govern the taxation of distributions from trusts. If enacted, the proposed amendments are to apply to the taxation of trusts for 2010/2011 and later income years. However, these new rules will only be a 'band-aid' interim measure until the Treasury finalises its rewrite of the Trust provisions.

These proposed amendments are designed to overcome some but not all of the problematic issues identified by the High Court's decision in the Bamford Case. That decision favoured the proportionate approach to the taxation of trust distributions, which resulted in uncertainty about the taxation effect of streaming specific types of income categories to beneficiaries. The draft legislation generally codifies some of the Australian Tax Office's administrative concessions in Taxation Ruling TR 92/13 and Practice Statement PSLA 2005/1 GA by providing for a mechanism to allow the streaming of franked dividends and capital gains to specific beneficiaries.

This Tax Flash summarises the effect of the proposed law if it is passed into legislation.

Essentially, the proposed amendments advocate a two tier methodology of dealing with trust distributions.

1. Streaming of capital gains and franked dividends, and capital gains based on specific entitlement even if the beneficiary is not presently entitled to any of the 'income of the trust'; and
2. Taxing the distribution of the remaining distributable trust income based on a proportionate approach.

As the taxation of the capital gain will be based on the beneficiaries' entitlement to the capital gain there will be no need to reclassify the capital gain as 'income of the trust'.

It is important to note that these changes do not solve all of the problems in relation to the taxation of trust distributions and the trust deed will have to be reviewed before the trustee makes its 30 June 2011 distributions to ensure the trust distributions can be taxed appropriately.

There will also be a limited anti-avoidance provisions relating to distributions to tax exempt beneficiaries, such as charities.

Example

The AB trust has three beneficiaries Mr Abernathy; Ms Bethany and AB Pty Ltd. The AB trust has the following income and gains for the 2011 tax year:

- ▶ \$1,000 capital gain (eligible for the general CGT discount);
- ▶ \$700 franked dividend;
- ▶ \$500 rental income; and
- ▶ \$300 interest income.

The trust deed contains streaming provisions allowing specific types of income and gains to be streamed to particular beneficiaries (this is a necessary condition in the draft legislation to allow streaming).

The trustee resolves to make the following distributions:

| Beneficiary | % of Certain Type of Income Category | \$ Amount |
|--------------|--------------------------------------|-----------|
| Mr Abernathy | 100% capital gain | \$1,000 |
| Ms Bethany | 100% of franked dividends | \$700 |
| | 100% of rental income | \$500 |
| AB Pty Ltd | 100% of interest income | \$300 |

New Rules

Under the new rules the tax effect of the distributions is as follows:

| Beneficiary | Type of Distribution | Taxable Distribution | Entitlement to Franking Credits | Entitlement to CGT discount |
|--------------|----------------------|----------------------|---------------------------------|-----------------------------|
| Mr Abernathy | Capital gain | \$1,000 | 0% | 100% |
| Ms Bethany | Franked dividends | \$700 | 100% | 0% |
| | 62.5% of remainder | \$500 | 0% | 0% |
| AB Pty Ltd | 37.5% of remainder | \$300 | 0% | 0% |

Current Rules

Under the current rules the tax effect of the distributions would be as follows (without any ATO administrative concessions):

| Beneficiary | Proportionate Entitlement | \$ Amount Distributed | Entitlement to Franking Credits | Entitlement to CGT discount |
|---------------------------------|---------------------------|-----------------------|---------------------------------|-----------------------------|
| Mr Abernathy | 40% | \$1,000 | 40% | 40% |
| Ms Bethany | 48% | \$1,200 | 48% | 48% |
| AB Pty Ltd | 12% | \$300 | 12% | 0% |
| TOTAL AMOUNT DISTRIBUTED | | \$ 2,500 | | |

Under the current law, streaming is not possible and each beneficiary would be taxed on their proportionate share of the total net income of the trust, with a proportionate share of the tax attributes of the franked dividends and capital gain flowing to all of the beneficiaries irrespective of whether they were entitled to the capital gain or franked dividends.

After the amendments, the ability to stream franked dividends and capital gains will, for tax purposes, result in the whole \$1,000 discount capital gain going to Mr Abernathy together with all of the entitlement to the 50% CGT discount. The entire \$700 worth of dividend income could be streamed to Ms Bethany as well as the entire amount of the attached franking credits.

The remaining \$800 income of the trust, comprising the \$500 rental income and \$300 interest income, would be distributed (for tax purposes) in proportion to each beneficiary's present entitlement to the remaining trust income. That is, \$500 (62.5%) to Ms Bethany and \$300 (37.5%) to AB Pty Ltd.

The above example deals with a simple situation. The new rules can get complicated in some circumstances, for example, where beneficiaries are not specifically entitled to all of the capital gains of the trust. You should discuss your own situation with your PKF Tax Adviser.

No Streaming of Other Income

The new rules only allow streaming of franked dividends and capital gains. Other income, such as interest, foreign income, rent and royalties and so forth, are taxed on a proportional basis. Assume in the example above that AB Pty Ltd was a non-resident company and the trustee intended to distribute the \$300 interest income to AB Pty Ltd in order to take advantage of the 10% withholding tax rate. Even after the proposed amendments, the streaming of the interest income would not be totally effective as only 37.5% (\$112.50) would be subject to the 10% withholding tax and the balance of \$187.50 would be taxed at the 30% corporate rate.

OPERATION OF NEW RULES

1. Streaming of Franked Dividends and Capital Gains

The ability to stream franked dividends and capital gains will not be determined by Division 6. Instead it will be dealt with under the specific parts of the Tax Act dealing with capital gains and franked dividends. Accordingly, the draft legislation contain amendments to the imputation credit provisions (207-B of the ITAA 1997) and capital gains tax (CGT) provisions (Division 115-C of the ITAA 1997) to ensure beneficiaries will be appropriately taxed on these streamed amounts.

Beneficiaries who are specifically entitled to capital gain and/or franked distributions derived by the trust will be taxed on the taxable capital gain and franked dividends along with their particular tax attributes (e.g. franking credits and CGT discounts). The associated tax attributes will flow to that beneficiary regardless of whether part or all of the amount is included in the 'income of the trust estate'.

The rest of the net income of the trust will be assessed on the proportionate basis.

In order for a beneficiary to be specifically entitled to the streamed capital gain or franked dividend, the trustee must have the power or obligation to distribute the capital gain or franked dividend to a particular beneficiary as a specific entitlement (most modern trust deeds give trustees this power or obligation but the trust deed would have to be reviewed to see if it needs to be amended). In addition, the trust accounts must record that the relevant beneficiaries have these specific entitlements.

Capital Gain

Division 115-C of the CGT provisions will be amended to ensure beneficiaries that are specifically entitled to a capital gain of the trust will be assessed on the taxable portion of that capital gain. This will be the case even where there is no 'income of the trust' for trust under trust law. The taxable capital gain distributed to the beneficiaries will be grossed up for any CGT discount and small business concessions, and the beneficiaries can then apply any capital losses, CGT discount and/or small business concessions if they are eligible to do so. This is regardless of whether part or all of the capital gain is included in the 'income of the trust estate'.

However, it will not be possible to deal separately with the taxable component and the discount component. That is, if a trustee applies a discount to a capital gain and distributes the taxable component to one beneficiary and the discount amount to another, each beneficiary will be treated as having a proportionate capital gain of both the taxable and discounted amount.

Also, where a trust has a discount capital gain that it wants to distribute to a specific beneficiary but the trust deed defines the income of the trust as the same as net income of the trust for tax purposes (under section 95 ITAA 1936), the trustee will have to make sure the discount proportion is also distributed to that beneficiary as a capital distribution, otherwise the other beneficiaries or the trustee will be taxed on part of the gain.

Franked Dividends

Division 207-B of the Imputation provisions will be amended to ensure beneficiaries that are specifically entitled to receive a franked dividend will have the appropriate share of the franking credit included in their assessable income and will be entitled to the appropriate share of the franking offset in relation to the dividend received by the trust.

In relation to franked dividends it should be noted that if there is no 'income of the trust estate' then it will not be possible to stream franked distributions (and associated franking credits) to a beneficiary (consistent with the current regime).

2. Taxing the Distribution of the Remaining Distributable Trust Income

After the identification of the capital gains and/or franked distributions that have been specifically streamed to specific beneficiaries, the next step will be to determine the remaining distributable trust income and the taxable amount for the remaining beneficiaries.

To do this, the first thing is to recalculate the distributable income and net income (taxable) to take into account the amounts that have already been streamed.

The draft legislation inserts new Division 5B into the ITAA 1936, which will exclude, from the Division 6 calculations, the capital gain and franked dividends specifically distributed to beneficiaries (and trustees if relevant). This is to ensure the streamed capital gain and franked dividends will be removed from the calculation of the income of the trust and net income of the trust so the balance of the net income of the trust can be taxed using the proportionate approach.

New Division 5B will also require re-calculating each beneficiary's 'present entitlement to income of the trust estate'. This will be done by reducing the amount of a beneficiary's present entitlement by their specific entitlements to any of the capital gain or franked dividends. This will prevent double taxation on capital gains and franked distributions.

ANTI AVOIDANCE PROVISIONS

The draft legislation includes anti-avoidance rules to prevent the use of tax exempt entities, such as charities, to 'shelter' taxable income.

1. Distribution to exempt entities must be paid

Firstly, within two months after the end of the income year, the trustee must notify the exempt entity that they are entitled to an amount distributed by the trustee and that amount must also be paid to the exempt entity within those two months. This requirement applies whether or not there is any tax avoidance purpose to the distribution to the exempt entity.

2. Specific Anti-avoidance Provision

In addition, where an exempt entity would otherwise be assessed on a disproportionate share of a trust's net income relative to their actual entitlements to the 'net taxable accretions to the trust' (whether 'income' or 'capital'), a specific anti-tax avoidance provision in proposed section 100AA of the 1936 Act will apply. This will counter tax avoidance through distributions to tax exempt entities where the amount of the actual distribution to the exempt entity is less than the adjusted net income distribution for that exempt entity. The 'adjusted net income' is, in effect, the taxable income of the trust less amounts that do not represent 'net accretions of value to the trust'. This takes into account notional tax amounts included in the taxable income e.g. franking credits, Division 7A deemed dividends, CGT market value substitution amounts etc.

There is already an anti avoidance provision in section 100A that could apply in some cases like this but it requires that there be a reimbursement agreement in relation to the distribution to the exempt entity, which would not always be easy to prove.

The operation of the specific anti-avoidance provision in section 100AA is illustrated in the following example:

ABC Family Business and Investment Trust had three beneficiaries: Mr Abcot, Mrs Abcot and the Stray Cats Home, which is an income tax exempt charity. For the 20010/11 tax year the trust earns \$1,000 in trading income and \$100 in interest income. The trust deed contains an income re-classification clause. This allows the trustee to exclude particular types of income categories as income of the trust estate and instead to treat it as capital of the trust estate.

The trustee (using the re-classification clause) resolves to reclassify the trading income as capital of the trust estate. This means the income of the trust is only \$100 interest income.

The trustee then resolves to distribute the \$100 income of the trust to the Stray Cats Home.

Without the anti-avoidance rules, as the Stray Cats Home would be entitled to 100% of the 'income of the trust' (\$100), it would be assessed on 100% of the \$1,000 taxable income of the trust (unless section 100A applied). However, as the Stray Cats Home is exempt from income tax none of the trust income would be taxed. The \$1,000 trading income could either remain in the trust or be lent out to Mr and Mrs Abcot.

The effect of the anti-avoidance rules will mean the trustee is taxed on the \$1,000 of the net income of the trust that has been 'sheltered' by the above arrangement. The trustee will be taxed on the amount at top marginal rates plus Medicare i.e. 46.5%.

The Commissioner will have a discretion to disregard this specific anti-avoidance provision where he considers its operation unreasonable.

Taxed to Trustee

The Draft Explanatory Memorandum says where the specific anti-avoidance rule applies or the two month reporting and payment rule is not met, the trustee will be assessed and taxed at 46.5% for the amount that would otherwise be 'sheltered'.

Should you require assistance or additional information, please contact your PKF Tax Adviser
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CONCLUSION

These proposed new rules appear to solve some of the main problems highlighted in the Bamford decision but there are still issues that need close consideration and it will be important to review the trust deed for each trust to ensure it operates appropriately.

In particular, the two month requirement for the payment of distributions to exempt entities appears too restrictive. This period should at least be extended until the lodgement date for the trust tax return for the relevant income year. PKF has made this point in a submission to Treasury.

The above comments are only a summary of the proposed amendments. If you have any questions please contact your PKF Tax Adviser.

FARM MANAGEMENT DEPOSITS

The Government also released another exposure draft bill that deals with trust distributions for trusts that are entitled to primary producers averaging and Farm Management Deposits (FADs). The proposed amendments will allow the trust beneficiaries to continue to use the income averaging and farm management deposit provisions in an income year where the trust does not have any trust law income to which a beneficiary is presently entitled e.g. where the trust is in loss for trust law purposes.