Content
- Why have a trust?
- Resettlement of trusts
- Present entitlement and taxation of trust income
- Proportionate approach to distributions
- Differences between taxable and distributable incomes
- SBE CGT concession: some points deserving attention
- Reimbursement agreements
- Areas of ATO interest
Thank the crusades for trusts

Why use a trust?
- Asset protection
- Estate planning
- Tax structuring

Motto for today: Read the deed!!!
- Not all deeds are created equal or the same
- The deed impacts the tax outcomes

Intention to create a trust
- Settlor
- Ensure the trust is not revocable

Trust property (subject matter of the trust)
- Property must be identifiable

Beneficiaries (objects of the trust)
- Beneficiaries must be identifiable
Role of the Settlor | 5

- Best to have an unrelated party in the role of settlor
- Why?
  - To minimise potential application of revocable trust provisions
- Not revocable:
  - if the settlor is a mere contingent beneficiary
- Revocable:
  - the settlor must have power to revoke or alter the trust so as to acquire a beneficial interest in the trust income or trust property or their children who are under 18 must acquire an interest in the trust income.

What’s the problem with resettlement? | 6

- What’s the tax problem with a resettlement?
- Beware of the CGT implications
- Some common scenarios:
  - A change of beneficiaries may result in a resettlement of a trust
  - A change in the membership of a continuing class of members will not constitute a change in the beneficial ownership
  - The change of trustee does not trigger immediate tax consequences (see TD 2012/21)
Resettlement depends on the facts

- Consider: *FCT v Clark* (2011) 79 ATR 550
  - Indicia of continuity identified in *FCT v Commercial Nominees* 2001 HCA 33 apply equally for the purposes of the income tax laws governing trusts.
  - Court held that changes were insufficient to have had that effect.
  - ATO argued changes had brought about a break in the continuity of the trust estate.

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- *FCT v Commercial Nominees* 2001 HCA 33
- High Court established that continuity of the trust must be assessed based on the:
  - Rules of the trust (trust deed)
  - Trust Property
  - Membership

- “Changes in one or more of those matters must be such as to terminate the existence of the eligible entity, or to produce the result that it does not derive the income in question, to destroy the necessary continuity” (Dowsett J)
In TD 2012/21:

- ATO acknowledged the approach set out in the decision in *FCT v Clark*
- Accepts that “continuity of trust is a function of whether the trust continues in existence under trust law in contradistinction to having terminated”
- A power to vary the trust deed must be used correctly within limitations of a particular trust

A trustee can be a beneficiary in a trust but it cannot be the only beneficiary

Trustee beneficiaries may impact the ability of third parties to make a claim against the assets of the trust

*Richstar Enterprises* case:

- the extensive control that the person had over the appointment of the trustees and distributions made by the trust created (at least) a contingent interest in the trust properties sufficient to bring them within the s 9 definition
What is vesting of a trust?
- Statutory vesting date – typically 80 years
- Could be something else – eg. death of family member
- Trust deeds:
  - Generally have default distribution mechanism to distribute trust fund on vesting date where trustee has not exercised discretion to distribute.
- Where the vesting date has been overlooked:
  - the trust fund will usually be held on trust by the trustee for a defined class of beneficiaries (‘primary beneficiaries’).

Vesting of the trust:
- Results in the primary beneficiaries becoming absolutely entitled to the trust fund
- CGT events E5 or E7 would likely occur (depending on the nature of the trust property)

The effect of CGT event E5 or E7 is that:
- the trustee will make a taxable capital gain on post-CGT assets: if MV > CB, and
- the beneficiaries would acquire the trust property at the vesting date with a CB = MV.

State duties and taxes may apply in relation to property
Entitlement in the trust deed:

- **Fixed Trust** - beneficiary with a fixed interest will be entitled to an amount commensurate with that interest
- **Non-fixed** (Discretionary) Trust - present entitlement will not arise until the trustee makes a determination

**Pearson v FC of T 2006 ATC 4352:**

- Unitholder not always presently entitled to fixed proportionate share of income without trustee determination
- Effects interest deductions relevant to borrowing to acquire units
Case V22: Knowledge of entitlement and inclusion in tax return:
- Beneficiaries unaware of their entitlements to trust income were not liable for additional tax for incorrect returns
- Trust income did not become "income" of the beneficiaries until they assented to their status as beneficiaries

Taxation Ruling IT 2651
- Commissioner does not accept Case V22 decision but is happy to remit penalties
- Literal interpretation of "omit" should apply

There is a distribution to a person and that person has a right when informed of it to say, if he pleases, 'I will not accept it'

Effect of making a Disclaimer - TD 2001/26
- A renunciation by a beneficiary of an actual interest in a discretionary trust
  - CGT event C2
- A disclaimer by mere beneficiary of discretionary trust:
  - no ongoing tax effect
  - no present entitlement for that relevant income year only
- A disclaimer by a default beneficiary
  - potentially negates entitlement for current year and all future years
Net income v Trust law income

- Net income of a trust estate
  - Taxable income as per s 95(1)
  - Beneficiary or trustee will be assessable under s97, 98, 99 or 99A

- Net income (s95(1)):
  - Total assessable income of the trust estate, less all allowable deductions.

- The net income should be calculated on the basis that the trustee is a resident

Income v Capital

- The trust deed definition of income and capital may not align with tax law definitions.

- Examples:
  - Share investments may be capital for trust purposes but subject to CGT for tax purposes
  - An amount of trust law income may be exempt income for tax purposes
  - Bonus shares are normally treated as capital for trust law purposes, but generally constitute assessable income for tax
  - A liquidator’s payment is assessable for tax purposes (s 47 ITAA36), but would normally be capital for trust law purposes
  - Net capital gains will be calculated differently to trust income
Where net income = trust law income:
- the beneficiaries will be entitled to the same share and character of net income.

However, this is only rarely the case.

Where trust law income < nil:
- no beneficiary will be presently entitled
- the trustee will be assessed on the income under s 99A.

Quantum view:
- Excess is assessable to the trustee under s 99A

Proportionate view:
- no amount assessable to the trustee under s 99A
Section 97(1):
- Relies on the presence of trust law income (i.e., income in accordance with trust deed or accounting principles)
- The proportionate or quantum approach cannot be applied satisfactorily if no trust law income

*Cajkusic v FCT*:
- Difficulties in applying either view where there is no trust law income and so the net income is assessed to the trustee under s 99A.

*Bamford v FCT*:
- High Court sanctioned proportionate approach as appropriate methodology

ATO: Notional amounts included in “income of trust estate”

Notional income
- An amount of assessable income taken into account in calculating the net income of a trust estate for an income year, that either does not represent any accretion (of either cash or value) to the trust estate in that year.
- Eg. Franking credits, CGT market value substitution

Notional expense
- An allowable deductible taken into account in calculating the net income of a trust estate for an income year, that either does not represent any depletion (in either cash or value) of the trust estate in that year.
- Eg. Capital allowances or write-offs
Income equalisation may cause problems

- “Where, for trust purposes, a trust’s distributable income is equated with its net income, notional income amounts may form part of the distributable income of a trust estate only to the extent that they are matched by notional expense amounts.”

Example (dividends and margin lending)

- A trust is entitled to $40,000 of franking credits.
- It also has a capital allowance expense of $30,000 which is not due to any decrease in value of the trust estate.
- Per TR 2012/D1, only $30,000 of the franking credits can be taken into account in calculating the distributable income.
- The remaining $10,000 cannot turn an overall loss for the year into a profit.

Section 100A:

- The term “reimbursement agreement” is defined as any agreement, arrangement or understanding providing for:
  - the payment of money (including a payment by way of a loan) to
  - the transfer of property to, or
  - the provision of services or any other benefits for,
  - any person other than the beneficiary, being an agreement entered into for a purpose (not necessarily the sole or principal purpose) of reducing the tax liability of a person

- Presence of reimbursement agreement triggers s100A
- Effect is that “distribution” and transactions relevant to reimbursement agreement are disregarded (i.e. negates present entitlement distribution)
- Trustee subject to tax
Raftland Pty Ltd v FCT:

- UPE (distribution) in favour of trust beneficiary
- Trust beneficiary was a unit trust with significant tax losses
- UPE distribution created an indebtedness but it was not a "real debt" that was intended to be paid

Held:

- The entitlement under the Raftland Trust deed was not intended to have substantive legal effect – "reimbursement agreement"
- s 100A(1) applied – no present entitlement effect for beneficiary
- trustee was taxed on income to which no beneficiary was presently entitled

"Other person" is not assessed on funds received
- The beneficiary is taxed at lower rates, utilises losses, non-resident etc.
- ATO considers such arrangement to be a 'reimbursement agreement'
- Ordinary family or commercial dealings are exempt from section 100A provisions
The trustee owns all of the shares in a private company. Company does not conduct any activities. Distributions are fully paid each year. Trustee essentially accumulates income.

- Resolutions must be done by 30 June
  - Trust deed may provide for an earlier date.
  - Advisable to have at least informal written records of the resolution made on the same day
  - A formal memorandum can be prepared after the end of financial year

- Specific entitlement issues:
  - to franked dividends must be done by 30 June
  - to capital gains must be done by 31 August – however, still 30 June!
  - can only be done if no beneficiary was previously entitled to that income
Character of capital gain ordinarily flows through to beneficiary

Specifically entitled to capital gain – Post-\textit{Bamford}

Consider:
- Company beneficiaries
- SBE CGT concessions
- Beneficiaries with capital losses

\textbf{Purpose:}
- where net capital gain flows through to a beneficiary, capital losses of the beneficiary can be applied in calculating the ultimate assessable amount before application of any discounts

\textbf{Three steps for beneficiary:}
1. Reversing any discounts claimed at trust level in calculating net capital gain included in trust net income
2. Grossed up amount is reduced by any available capital losses, and
3. Applicable CGT discounts is reinstated as recalculated on the reduced amount (together with a deduction to overcome any double counting of income as a result of the gross-up)
Subdivision 115-C: capital gain flow through | 31

- If only general 50% CGT discount was claimed:
  - a multiple of 2 is used as the gross-up factor
- If both general and CGT small business discounts were claimed:
  - a multiple of 4 is used as gross-up factor
- Any capital losses of the beneficiary then applied to grossed-up amount, and
- The beneficiary then reapply the applicable discount to this reduced amount

Tips for streaming capital gains | 32

Streaming of trust’s net capital gains:
- Trust deed must allow streaming
- Beneficiaries must be made specifically entitled to all or part of the net capital gains
- Gains calculated using market value substitution rule cannot be streamed
What is it?
- Relevant for fixed trusts
- Happens when a beneficiary receives a non-assessable payment from the fixed trust which exceeds the cost base of the interest in the trust
- Gives rise to cost base reduction or assessable gain

Examples of non-assessable payments:
- Deductions for capital works (Division 43)
- SBE 50% active asset reduction on capital gains (Subdivision 152-C)
- Frozen indexation amounts
- Timing differences (ATO ID 201/63)

Records need to be retained tracking all adjustments to the cost base
- Private Ruling 1011825048863

Rateable reduction
- Relevant where a trust has:
  - a total of franked distributions and/or capital gains > the trust’s net income for the year.
- The formula (found in s115-225) is:

\[
\frac{\text{Taxable income of the trust (excluding franking credits)}}{\text{Net capital gain } + \text{net franked distributions}}
\]
Example:

- Trust’s income consists of a franked distribution of $7,000 and a trading loss of $5,000.
- Entitlement to franking credits is $3,000
- Trust’s taxable income excluding franking credits is $2,000.
- The rateable reduction formula would give:
  \[ \frac{2,000}{(0 + 7,000)} = 0.2857 \]
- Franked distribution is multiplied by the result
  \[ 7,000 \times 0.2857 = 2,000 \]
- Franking credit entitlement of $3,000 remains intact.

Eligibility for CGT small business concessions

- Basic conditions – be an SBE, etc
- CGT events relevant to buying/selling business

CGT small business concessions available

- the 15-year asset exemption
- the 50% reduction for active assets
- the retirement exemption, and
- the small business asset roll-over

Tracing through trusts is critical for the concessions!
Small Business Entity (SBE) requirements:
- SBE must carry on a business and satisfy a $2m "aggregated turnover" test.
- Can be based on aggregated turnover for the previous year or the current year.
- Aggregated turnover is sum of SBE annual turnover and the annual turnovers of connected or affiliated entities.

Maximum net asset value requirement:
- Test is met if the net value of the CGT assets of the taxpayer, its connected entities and affiliates does not exceed $6m.
- The net value is based on the amount by which the market value of assets exceeds the liabilities.

Connected entities
- Entities under direct control or common control.

Control of a non-discretionary trust
- At least 40% of income distribution.
- At least 40% of capital distribution.

Control of a discretionary trust
- Trustee acts or is expected to act in accordance with directions.
- In preceding four income years trustee distributed at least 40% of total income or capital.
Affiliates

- An individual or a company is an affiliate of a taxpayer if:
  - Acts in accordance with directions
  - Reasonably expected to act in accordance with directions
  - Acts in concert with the taxpayer
  - In relation to the business of the individual or company

- Trusts cannot be affiliates of other entities, only connected entities

Active asset requirement

- The 80% rule is a “look through” test to ensure interests / units in trusts meet the active asset test:
  - Market values of active assets;
  - Financial instruments inherently connected with the business;
  - Cash inherently connected with the business

- Must exceed 80% or more of the market value of all assets of the trust
Connected entity – Control (other than discretionary trust)

First entity

- >40% of income
- >40% of capital

Control of a discretionary trust

First entity

- Trustee acts in accordance
- Any of the 4 years before >40%
A CGT concession stakeholder is defined to be:

- A significant individual or
- The spouse of a significant individual

A significant individual is:

- an individual with a small business participation percentage of at least 20%
- The spouse must have a small business participation percentage that is greater than zero.

Direct interest in discretionary trusts is the smallest of:

- % of income actually distributed during the current year
- % of actually capital distributed during the current year

Note:

- Can be all capital or all income.
- If both, the % is the smaller of the two.
- If no distributions made of income or capital – there will generally be no significant individual, but trustee can nominate up to 4 individuals as significant individuals.
Read the deed!
• Resolutions – proportionate approach requires percentages
• Consider the definition of “income in the trust” in deed
• Distribution deadlines
• If varying deed – consider resettlement issues
• Trusts with net capital gains – consider streaming possibilities before resolving to distribute all income
• Labels on the trust’s income tax return – one of the focus area of the Trust Taskforce

Any questions ??????

Thank you for attending today’s webinar – we would really appreciate if you could take the time to complete the survey