

Rigby Cooke Tax Update

New Trust Streaming Measures

New trust streaming measures applying to the year ending 30 June 2011 and beyond

Key points

- Trustees should review trust deeds to ensure streaming capital gains and franked dividends is possible and to ensure there is sufficient flexibility to determine what is distributable to beneficiaries.
- Trustees must first consider the proposed law before 30 June 2011.
- Trustees must consider the impact of the new law and optimising ultimate tax outcomes when drafting their distribution resolutions for the year ending 30 June 2011.
- Trustees considering making tax exempt entities entitled to income of the trust must consider the proposed new anti-avoidance measures.
- The Australian Taxation Office (“ATO”) is already focusing on trust deeds and resolutions.

Background

On 2 June 2011 the Government introduced into Parliament Tax Laws Amendment (2011 Measures No. 5) Bill 2011 (the “**Bill**”). The Bill is an interim measure in the broader update and rewrite of Division 6 of Part III of the *Income Tax Assessment Act 1936* (“**Division 6**”). The Bill deals with the streaming of franked dividends and capital gains for tax purposes and introduces anti-avoidance rules for distributions to tax exempt entities.

Who is affected?

The proposed streaming changes will affect trusts that have net (taxable) income and make a capital gain or are in receipt of a franked distribution in the year ending 30 June 2011 and after.

Important considerations

Trust deeds should be reviewed to ensure streaming capital gains and franked dividends is possible and to ensure that there is sufficient flexibility to determine what is distributable to beneficiaries. In this respect, if the trust deed does not include an income re-characterisation clause, it may be possible to stream capital gains under the proposed law pursuant to a capital advancement power in the trust deed.

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Trustees will need to record in the accounts or records of the trust (e.g. distribution resolution) that a beneficiary is 'specifically entitled' to an amount of franked distribution on or before 30 June (and on or before 31 August for capital gains). Importantly, while a two-month concession exists in the proposed law for capital gains, some trust deeds may require that the trustee make their resolutions by 30 June.

The resolutions of trustees must be drafted in accordance with the terms of the particular trust deed and the law. Recent ATO review and audit activity has revealed trust deeds and resolutions are already a key focus.

Summary of the proposed legislative changes

Streaming changes

Under the Bill, for streaming to be effective a beneficiary must be 'specifically entitled' to the capital gain or franked distribution. A beneficiary will be specifically entitled to the extent they receive or can reasonably be expected to receive a financial benefit referable to the capital gain or franked distribution. Assessment is based on a specific entitlement to a capital gain or franked distribution of the trust (i.e. a quantum approach).

Where there is no specifically entitled beneficiary to an amount representing a capital gain or franked distribution, the Bill proposes to revert to ordinary taxation of trusts principles, that is, the proportionate approach.

Importantly, only entitlement to the franked distribution amount is required (not the grossed-up amount) whereas entitlement to discount capital gains must be for the gross amount (pre-discount). If a grossed-up franked dividend amount is being streamed, the franking credits will be allocated based on the quantum of the whole entitlement applicable for each beneficiary. Capital gains may be streamed on a gain by gain basis.

Exempt entity distributions

The Bill's proposed anti-avoidance rules target the use of exempt entities to inappropriately reduce the tax otherwise payable on the taxable income of a trust.

The first anti-avoidance measure proposes to treat an exempt beneficiary that has not been notified of or paid their present entitlement to income of the trust estate within two months of the end of the income year as not being and never having been presently entitled to that income.

The second anti-avoidance measure proposes to treat an exempt entity as not being and never having been presently entitled to an amount of income that exceeds a prescribed benchmark percentage which is calculated by reference to the amount to which the exempt entity is purportedly made presently entitled and the trust estate's adjusted net income for the year.

Under both proposed anti-avoidance measures, the trustee will generally be assessed on the share of the trust's taxable income that corresponds to the income to which the exempt beneficiary is not entitled.

Apply the existing law or the proposed law?

As the Bill may not receive royal assent before 30 June 2011, the ATO has released administrative guidance setting out its intended practice regarding enforcement.

Broadly, the ATO will not seek to levy shortfall penalties and any interest levied would be at the base rate where a taxpayer amends their return to increase a tax liability within a reasonable time and the taxpayer applied the:

- o existing law at the time for lodgment and the law was retrospectively amended; or
- o proposed law and it is not enacted as introduced (for example, because amendments were made during the Parliamentary process); or
- o proposed law and it is not enacted.

Case Studies using the Proposed Law

A. Streaming franking credits: net and no net franked distribution income

In the 2011 income year, the Alabaster Trust derives net rental income of \$80,000 and a franked dividend of \$140,000 (with \$60,000 of franking credits) from shares in Apples Pty Ltd. The trustee had interest expenses of \$120,000 on borrowings used to purchase the shares in Apples Pty Ltd and \$60,000 on borrowings used to purchase its investment property. The trust's income is \$40,000 and its taxable income is \$100,000.

The Alabaster Trust has two beneficiaries, Alexandra and Stephanie. The trust deed specifies that Alexandra is entitled to net franked dividends and Stephanie is entitled to all other income.

Alexandra is entitled under the trust deed (and therefore under the proposed law 'specifically entitled') to \$20,000 being the net franked dividends. It follows that she receives all of the franking credits of \$60,000. Accordingly, Alexandra would include \$80,000 in her assessable income and Stephanie would include \$20,000 in her assessable income being the balance of the net income of the Alabaster Trust.

Now assume the facts were altered and the interest expense on borrowings used to purchase shares in Apples Pty Ltd was \$140,000. As there would be no net franked dividend income, Alexandra is not specifically entitled to any amount. Stephanie would be entitled to all of the Alabaster Trust's income (\$20,000). As Stephanie would be entitled to all of the income of the Alabaster Trust and no-one would be specifically entitled to any of the franked dividend, Stephanie's share of the franked distribution equals all of the dividend. Accordingly, Stephanie would receive all of the franking credits. Stephanie would include in her assessable income \$80,000 being the \$20,000 net rental income and \$60,000 franking credits.

B. Revaluation of property and streaming capital gains

The Yaksi Trust purchases an investment property in July 2006 for \$400,000. The trustee of Yaksi Trust uses its power under the trust deed to revalue the property according to generally accepted accounting principles and treat the increase in its value as income of the Yaksi Trust. For each of the 2007-2010 income years the trustee revalues the property upwards by \$100,000 and treats this as income of the trust. For each of those four income years the trustee makes Douglas presently entitled to that revaluation "income".

In the 2011 income year the property is sold for \$1m. The trustee makes an accounting gain of \$200,000 (i.e. \$1m less the revalued amount of \$800,000). The trustee distributes the \$200,000 accounting gain to Magnus.

Under the proposed law, Douglas would be specifically entitled to two thirds and Magnus would be specifically entitled to one third of the \$600,000 capital gain. Additionally, as the CGT discount would apply to the capital gain, Douglas and Magnus would be specifically entitled to the non-assessable component of the capital gain that is reflective of their percentage share of the capital gain. That is, the outcome under the proposed law is that Douglas would be specifically entitled to a discount capital gain of \$400,000 of which \$200,000 would be non-assessable; Magnus would be specifically entitled to a discount capital gain of \$200,000 of which \$100,000 would be non-assessable.

By contrast, under the current law, this scenario would result in Magnus (or the trustee of Yaksi Trust depending upon the terms of the Yaksi Trust deed) bearing the full tax burden of the capital gain.

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