TRUST SERIES – PART 2

How trusts are taxed in Australia

Presented by

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Questions?

Please ask questions through the Q & A pod not on the chat pod.

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Introductory remarks

- This is a critical, complex and often misunderstood area of trusts
- Seemingly simple – distribution, pay the tax and move on
- Law behind it is complicated
- Significantly changed following Bamford and the re-write of Div 6
- Div 6 is a bit of a mess – doesn't work very well. Now have the divide into codifying separate CGT and Franked Dividend provisions, which don't apply Div 6 (Subdivision 115-C and 207-B)
- Sounds harsh, but failure to understand this means that one should be advising the setup of the trust structure. Could be exposing controllers to the top marginal tax rate. Lucky we will all understand it after this webinar!

Contents

- A summary of the tax provisions that assess trustees and beneficiaries of trusts.
- The proportionate approach to the taxation of trust income.
- The impact of the 2010 Bamford High Court decision.
- The concept of "present entitlement".
- The taxation of trustees, including beneficiaries with legal disabilities and beneficiaries who are foreign residents of Australia.
- When the withholding tax provisions apply to a trustee.
- When punitive tax rates apply to a trustee.
- The taxation of minors.
- The proper approach to how trust distribution minutes should be drafted.
- Streaming of capital gains made by a trust to beneficiaries
- Streaming of franked distributions received by trusts to beneficiaries.

Summary of the law

- Division 6 is the key tax provision

- Subdivision 115-C deals with the taxation of trustees and beneficiaries in relation to capital gains made by a trust. Due to the operation of Division 6E, just mentioned, capital gains made by trusts are dealt with, almost exclusively, under subdivision 115-C.

- The key provision that includes trust income in the assessable income of a beneficiary is subsection 97(1) of the 1936 Tax Act:

  - "…where a beneficiary of a trust estate who is not under any legal disability is presently entitled to a share of the income of the trust estate, the assessable income of the beneficiary includes so much of that share of the net income of the trust estate as is attributable to a period when the beneficiary was a resident…"

Summary of the law (continued)

- Key definitions
  - “a share of the income of the trust estate”;
    - refers to a percentage entitlement of the income to which a beneficiary is presently entitled of the distributable or trust law income of the trust.
  - “so much of that share”;
    - refers to the percentage of the distributable income that a particular beneficiary is presently entitled to.
  - “the net income”.
    - refers to the net income as defined in subsection 95(1). This is a tax concept.

Proportionate method – how it works

- The trustee determines the amount of distributable income of the trust.
- The trustee determines what percentage of that distributable income each beneficiary is to receive.
- The net income of the trust is determined.
- To determine the amount to be included in the assessable income of a beneficiary, the percentage determined in step 2 is multiplied by the net income determined in step 3.

Proportionate method – how it works (continued)

Example

- E.g., a trustee has determined the distributable income of a trust to be $100,000 for an income year. There are two beneficiaries that are presently entitled to this income. Beneficiary A receives $60,000 of the distribution and Beneficiary B receives $40,000. The net income (the taxable income of the trust) is $120,000. The assessable income of the two beneficiaries is calculated as follows:

    - For Beneficiary A, you work out the share of the distributable income of the trust to which that beneficiary is presently entitled. This is 60,000 divided by 100,000. This share, or percentage, is then multiplied by the net income of the trust to give $72,000. This amount is included in the assessable income of the beneficiary.

    - For Beneficiary B, the same formula is followed to include $48,000 in that beneficiary's assessable income.

- The **proportionate approach** allows the beneficiary to include their portion of the net trust income in their assessable income.

- The **quantum approach** is where the beneficiary includes in their assessable income the distributable income to which they are presently entitled.

Present entitlement

- Concept: For an amount to be included in the assessable income of a beneficiary, the beneficiary must be "presently entitled" to a share of the distributable income of the trust.

Present entitlement (continued)

- It is a case law principle – requirements
  - A beneficiary must have an indefeasible, absolutely vested, beneficial interest in possession in the income of the trust and must be able to demand immediate payment of the trust income. If the beneficiary is under a legal disability, the beneficiary's interest must be such that, but for that disability, he or she would be able to demand immediate payment. *Taylor v FCT* (1970) 119 CLR 444, *FCT v Whiting* (1943) 68 CLR 199; 7 ATD 179.
  - A beneficiary may be presently entitled notwithstanding that the beneficiary is not aware of the existence of the trust or his or her entitlement: *Vegners v FCT* (1991) 91 ATC 4213 and *Ramsden v FCT* [2005] FCAFC 39.
  - A beneficiary does not cease to be presently entitled to income merely because the income has been distributed to persons not entitled to it.
  - A beneficiary can only be presently entitled to income that is legally (that is, according to trust law), available for distribution to the beneficiary, even though at the relevant time it may not actually be in the trustee's hands for distribution.

Present entitlement (continued)

- Extended by s95A of ITAA 1936 to include:
  - If a beneficiary has been presently entitled to income of a trust, the beneficiary is deemed to continue to be presently entitled even if the income has been paid to, or applied for the benefit of the beneficiary; and
  - If a beneficiary is technically not presently entitled to income but has a vested and indefeasible interest in the income of a trust, the beneficiary is then deemed to be presently entitled.

Present entitlement (continued)

- Situations where the beneficiary is not taxed on the trust income:
  - Legal disability (s98(1)): E.g., minors, undischarged bankrupts or mentally incapacitated. Trustee is assessed.
  - Non-resident beneficiaries – business income or rental income: generally not a final tax (beneficiary still needs to lodge a return, with a credit for tax paid by trustee).
  - Non-resident beneficiaries – dividends, interest or royalties (s128A of ITAA 1936): withholding tax applies (interest at 10%, dividends at 30% unless fully franked, royalties at 30%). No tax return required from beneficiary. Can be varied by a treaty. Whether a person is a non-resident for this purpose is determined by address or bank account.
  - Income not included in the assessable income of a beneficiary (s99 and 99A of the ITAA 1936): trustee assessed at top marginal rate under 99A. There is Commissioner discretion to not apply it, but basically never happens. If 99A doesn't apply, s99 may apply which assess trustee at a rate as if it was a resident individual (with no deductions). S99 generally reserved for deceased estates prior to administration (as no beneficiary can be presently entitled prior to administration).

Drafting distribution minutes

Suggested approach to drafting minutes

1. Read the trust deed – understand the trustee powers
2. Determine the distributable income
3. Determine the net income of the trust
4. Ensure that the beneficiaries to whom distributions are to be made are valid beneficiaries.
5. Roughly calculate the tax payable by all beneficiaries and adjust the distributions as necessary.
6. Draft the distribution minute clearly
7. Finalise
8. Lodge returns consistently with the minute

Streaming and Bamford

- Bamford outcome:
- Not a change in the law – it is a clarification of s97(1)
- Led to a law change – 'specific entitlement'
- ATO concluded there was no ability to stream different types of assessable income to selected beneficiaries.
- The tax law was changed to permit the streaming of capital gains and franked distributions. These changes introduced the concept of "specific entitlement" to capital gains and franked distributions and created another way, other than "present entitlement" on which a beneficiary could be assessed.

Streaming and Bamford (continued)

- Taxed on Beneficiary has to be made specifically entitled within the terms of the trust deed

- Amounts to which a beneficiary is specifically entitled are streamed to the beneficiary on a quantum basis — as distinct from the proportionate basis applicable under s. 97. This means that the beneficiary is the specific amount to which it is entitled, as well as on the tax attributes of that specific entitlement (i.e. a beneficiary who is specifically entitled to a franked distribution is also taxed on the franking credits associated with the franked distribution).

  - The **proportionate approach** allows the beneficiary to include their portion of the net trust income in their assessable income.

  - The **quantum approach** is where the beneficiary includes in their assessable income the distributable income to which they are presently entitled.

Streaming and Bamford (continued)

- Amounts that are not streamed to beneficiaries flow proportionately to the beneficiaries based on their *adjusted Div 6 percentage*, or they may be assessed to the trustee.

- Subdivisions 115-C and 207-B. Subdivision 115-C relates to capital gains made by trusts and subdivision 207-B relates to franked distributions received by trusts.

- Subdivision 115-C – the benefit of a discount capital gain realised by a trust can flow to a beneficiary in certain circumstances.

- Subdivision 207-B – the benefit of franking credits attached to dividends received by a trust can flow through to beneficiaries subject to certain requirements. (note: 45 day/holding rule applies). Also note anti avoidance rules that could apply, e.g. benchmark rule

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Trusts and capital gains

- Section 115-228 says the gain to which a beneficiary is specifically entitled is determined by reference to the financial benefits which the beneficiary obtains (or can expect to obtain) that are referable to that gain

- Subdivision 115-C of the ITAA 1997 applies to capital gains which are now essentially streamed through on a quantum basis (i.e. taxpayer taxed on what they receive).

- 'Example: A Trust has a discountable capital gain of $200,000, and carried forward losses of $20,000. The trustee wants to distribute 60% of the capital gain to person A, and 40% of the capital gain to person B.

- How it works:
  - Determine the distributable income: $180,000 ($200,000 less $20,000)
  - Distribution minute: $108,000 to person A, $72,000 to person B
  - Net income: 50% of $180,000 = $90,000

Trusts and capital gains (continued)

- For each beneficiary – shown through example for person A:
  - Determine the amount that the beneficiary is specifically entitled to (i.e., gross capital gain) – follows legislative formula

$$\text{Capital Gain} \times \frac{\text{Share of net financial benefit}}{\text{Net financial benefit}}$$

$$\$200{,}000 \times \frac{\$108{,}000}{\$180{,}000}$$

$$= \$120{,}000$$

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Trusts and capital gains (continued)

- Determine the share of the net capital gain (only relevant where there is no beneficiary specifically entitled to any amount of the gain – NA here). When there is no beneficiary specifically entitled to an amount of a capital gain, the law allocates that amount of the gain to beneficiaries in the trust in accordance with what is known as their "adjusted Division 6 percentage". This term is defined to mean, broadly, the percentage of the distributable income the beneficiary receives from the trust without regard to capital gains or franked distributions to which any beneficiary is specifically entitled.

Trusts and capital gains (continued)

- Determine attributable gain

$$\text{The amount of the capital gain after taking into account capital losses and applicable discounts} \times \frac{\text{The beneficiary's share of the capital gain}}{\text{The amount of the capital gain}}$$

$$\$90{,}000 \times \frac{\$120{,}000}{\$200{,}000}$$

$$= \$54{,}000$$

- Amount to be included in beneficiary's assessable income (i.e., any gross up)
  - 50% discount applied here, so double $54,000 = $108,000

Trusts and capital gains (continued)

- Note: Subdivision 115-C is long winded and complex – but often gets the intuitive answer (e.g., $108k here!)

- Remember to then apply any of the beneficiary's respective capital losses, then discount = $54,000

Trusts and franked distributions

- Subdivision 207-B ITAA 1997 is the tax provision that deals with franked distributions and includes in the assessable income of the beneficiary the share of the dividend received by a beneficiary and also the applicable share of the franking credit, if any, attached to the dividend.
- A little similar to capital gains, but the income is normally a part of the distributable income of the trust
- Franking credits – not included in profitable and loss (leads to a difference in net/accountable income and taxable income of the trust)

Trusts and franked distributions (continued)

- Calculation: Assessable income of each beneficiary
  - Calculate specific entitlement:

$$\text{Franked distribution} \times \frac{\text{Share of net financial benefit}}{\text{Net financial benefit}}$$

  - Entitlement to franking credits

$$\text{Amount of the franking credit on the franked distribution} \times \frac{\text{Entity's [beneficiary's] share of the franked distribution}}{\text{Amount of the franked distribution}}$$

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