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Current Issues with Trusts

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CONTENTS

1 Introduction

This paper addresses a 'grab bag' of tax issues related to the use of trusts as vehicles for business or investment.

While there has been no trust tax reform as a result of the Discussion Paper released by Treasury in November 2011, and though it is hoped there will be reform as a result of the 'Re:think' tax reform process which should result in a green paper and then a white paper, there have been developments on the margins in the taxation of trusts that practitioners need to be aware of.

Little of the material included in this paper is 'new'. The developments on the margins involve either the ATO clarifying their interpretation of long standing provisions (e.g. section 100A or the way that 170(1) could apply to trustees without assessments) or the 'bedding in' of recent changes such as the streaming measures introduced in 2011 or the ATO change in stance over UPEs in December 2009. Also addressed is the current interest that seems to be emerging around the tax consequences of the vesting of a trust.

The issues to be covered in this paper are:

- Distribution resolutions, time and content
- UPEs and Division 7A, and the ATO 'fix'
- UPEs and section 100A
- The consequences of vesting
- Disclaimers and renouncing trust interests
- Changing the trust relationship and resettlements
- Trusts mischaracterising receipts
- Time limits on raising trustee assessments
- Distributions of discountable capital gains to non-residents

References in this paper are to the *Income Tax Assessment Act 1936* (ITAA1936) and the *Income Tax Assessment Act 1997* (ITA1997).

2 Distribution resolutions, time and content

2.1 Resolutions

A beneficiary of a trust is only taxed to the exclusion of the trustee (except in limited cases such as where the beneficiary is non-resident, under a legal disability, etc.) where the beneficiary is presently entitled to a share of the income of the trust estate for the purposes of subsection 97(1).

A beneficiary is made presently entitled to income through the terms of a trust instrument, which may require a decision to be made by the trustee, often referred to as a resolution, although it may take the form of a minute, list or notice depending upon the requirements of the trust instrument.

2.2 Timing

Although the tax legislation silent on when the present entitlement must be created, case law indicates that to create a present entitlement to income it is necessary to create that entitlement prior to the end of an income year[1]:

> Present entitlement to the income must arise, if at all, at the latest by the end of the year of income.

Although some commentators have railed against the fact that there is not requirement under trust law for an entitlement to income of the trust estate to arise prior to the end of an income year for a person to be entitled to that income, it appears to be generally accepted by most practitioners, and required by the ATO that the present entitlement be created prior to the end of an income year.

The distribution resolution (the decision to appoint the minute) needs to conform with the terms of the trust deed, and if a corporate trustee is in place its resolutions will need to comply with the requirements of the *Corporations Act 2001* (that is that circular resolutions are signed, meetings minuted within time (section 251A)) and the requirements of the relevant company constitution.

In some trust deeds there is a requirement that the decision to appoint the income of the trust estate prior to the end of the income year (for instance, that the decision be made by 28 or 29 June) and if that is a requirement of the trust instrument it must be met.

Under the streaming provisions (discussed later in this paper) there is a requirement that where a decision is made to stream franked distributions that this is recorded in writing in the accounts or records of the trust on or prior to 30 June – this means that when streaming such amounts it is not possible to sign a minute of meeting after 30 June recording a pre-30 June decision without having some other record of the decision made on or prior to 30 June.

The streaming provisions do not require, by contrast, any decision to be recorded in the accounts or records for capital gains that are streamed until 31 August following financial year-end.

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[1] *Trustees of the Estate Mortgage Fighting Fund Trust v FC of T* 2000 ATC 4525

2.3 Content

The following points, which are likely to be uncontentious, can be made about the content of a resolution recording the appointment of income. It is noted that some resolutions, following the decision in *Bamford* and the streaming measures being introduced have ended up being quite 'long-form'. Although such resolutions can assist in showing that the proper clauses of the deed have been considered and that they are present in the deed, in practice using a long form distribution is fraught with difficulty. Experience has shown that some practitioners will adopt a standard long-form resolution without considering whether it fits within the terms of a particular deed, or whether it is appropriate to the circumstances. This has caused the trustee to do things that it is not empowered to do under the trust instrument such as determining income to be tax law income.

The points below should be considered a minimum requirement. The ATO have published a checklist which contains some of these points[2].

- It should be clear who has made the decision and that person should be the person empowered to make the decision under the trust deed.
- If there is someone that needs to consent to the appointments made in the record of the decision it should be clear that the consent has been obtained (for instance a guardian or appointor may need to provide prior written consent – and that consent should be obtained).
- It should be clear what decision was made in relation to income of the trust estate, and preferably should use the terminology used in the trust deed to define income that is being dealt with in the distribution minute.
- The distributions should be to beneficiaries that are permitted to be distributed to under the trust deed.
- If streaming is intended to occur, streaming should occur first in the order of what the trustee has resolved – it is not possible to stream a capital gain or franked distribution as part of a 'balance' amount.
- It should be clear what each beneficiary is entitled to, either in dollar amount, percentage amount, or formula.
- Unless percentages are being used consider when setting out amounts in dollar terms 'the first $X, the second $Y, etc.' so that if the income of the trustee estate is determined to be a different amount, who has benefited from the distribution of income is clear.
- Unless percentages are being used, consider having a 'balance' beneficiary. You should not be attempting to stream classes of income other than capital gains or franked distributions unless you want to have a potential argument with the ATO over whether such streaming can occur (case law supports the proposition that streaming of other classes of income cannot occur[3]).

[2] https://www.ato.gov.au/printfriendly.aspx?url=/General/Trusts/In-detail/Trust-tax-time-toolkit/Resolutions-checklist/

[3] *FC of T v. Greenhatch* [2012] FCAFC – as was noted in Ken Schurgott's paper at the WA State Convention in November 2014 there appears to be another case which may determine differently whether streaming can occur – *Thomas v FCT* which has not yet been handed down.

2.4 Contingent resolutions

In TD 2012/22 the Commissioner makes clear his view that a resolution that attempts to deal with income that was not thought to exist at the time the resolution was made will fail. His example 6 is an includes a resolution which has commonly been made in the past:

> On 30 June 2011, the trustee resolved to distribute the income of the trust equally between two individual beneficiaries, Daisy and Rose. The trustee further resolved that should the Commissioner later include any amount in the assessable income of the trust, the amount so included is deemed to be distributed on 30 June to Bouquet Pty Ltd.

The Commissioner's position is that on 30 June 2011 there is no amount that the company, Bouquet Pty Ltd, could be seen to be entitled, as all of the income entitlements had been allocated between the two individual beneficiaries.

The Commissioner maintains that the same outcome would arise in Example 7 where the facts are different. In that case the trustee thought the trust income, which was equated with section 95 net income, was $100,000. The trustee allocated $50,000 each to Daisy and Rose. The trustee tried further to resolve that:

> should the Commissioner later include any amount in the assessable income of the trust, the amount so included is deemed to be distributed on 30 June to Bouquet Pty Ltd

The Commissioner's view is that such a resolution could not take an increase in assessable income to the company, Bouquet Pty Ltd, as the company's entitlement was contingent upon the Commissioner determining the income to be different than that thought to be the amount determined by the Commissioner. Present entitlement does not exist where the entitlement is contingent. The outcome should be different however where rather than making the distribution conditional upon the Commissioner later including an amount, the trustee had merely resolved that 'the balance will be distributed to Bouquet Pty Ltd'. Such a resolution is merely contingent on there being such income, in the same way that the distribution to the other beneficiaries, Daisy and Rose is contingent upon there being sufficient income to be distributed to them.[4]

The draft minutes of the NTLG Trust Sub-group meeting of 18 September 2012, indicate that the ATO was asked about a formulaic resolution phrased in the following way:

> an amount of trust income (to the maximum extent it is available) that would ensure that Harry's share of the net income of the trust as determined under section 97 of the ITAA 1936 does not exceed $30,000; or
>
> an amount of trust income (to the maximum extent it is available) that would ensure that Zac's total taxable income for the 2012 income year does not exceed $80,000

The ATO stated that after considering, and accepting, that he will as far as possible try to give effect to an income equalisation clause (equating trust income to section 95 net income):

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[4] See the discussion on contingencies and their impact on present entitlement in Bernard Marks, *Trusts & Estates Taxation and Practice,* 2nd Edn, 26-145.

> Where the calculation of the net income depends on the exercise of a choice by the trustee, the Commissioner's approach, unless there is evidence to the contrary, will be to assume that the trustee had determined how it would be made prior to 30 June, and that the calculation of the net income of the trust does not vary as between different beneficiaries. In that way, beneficiaries will be treated as having a vested and indefeasible interest in the trust income by 30 June wherever possible. On this basis, formulaic resolutions of the first type (set out above) would generally be effective to create the purported entitlements. However, the Commissioner is not inclined to include such resolutions as examples in the final Determination due to their ostensible purpose of ensuring certain tax outcomes as opposed to particular trust entitlements.
>
> Resolutions of the second type are less certain and the Commissioner would not generally accept such a resolution as being effective to create a present entitlement to the income of the trust by 30 June. There are many matters which may happen after 30 June which could affect the calculation of the beneficiary's taxable income - each may have various choices to make under the tax law.
>
> It is also difficult to see how a resolution of this second type would operate in respect of an entity that is a beneficiary of two trusts where the trustees of both trusts had made similar resolutions.

In the second type of resolution however, what would happen if there were no matters that could impact on the beneficiary's taxable income following financial year end, for instance where they only had other income consisting of salary and passive income? Presumably in this case such a resolution would be effective, but would be challenged by the Commissioner.

3 UPEs and Division 7A, and the ATO 'fix'

Another session, immediately prior to this one at the NSW Tax Forum, is to cover Division 7A issues in detail. I have confined myself here to some discrete issues in relation to the 'sub-trust' arrangement that the ATO set out in their Practice Statement PSLA 2010/4, that operates to allow funds to remain in the trust for a period of up to 7 or 10 years (depending upon the interest rate) under an arrangement that is effectively an interest only loan.

The ATO view formalised in December 2009 that an amount owed by a trustee to a private company beneficiary as a result of unpaid distributions (a 'UPE') could be treated as a loan by the private company to the trustee would ordinarily result in a such a loan needing to be repaid by a particular time or brought under a loan agreement complying with the terms of section 109N of ITAA1936 to prevent there from being a deemed dividend.

Many trust arrangements established prior to December 2009 relied on income being able to be effectively retained in the trust, but subject to tax in the hands of a corporate beneficiary at 30%, in order to allow the trustee to pay down debt, or fund working capital.

While funds could be retained in a trust where they are owed to a corporate beneficiary under a Division 7A loan agreement, the requirements of Division 7A to make principal and interest payments on a yearly basis results in a tax or cash flow 'leakage' as either funds are paid to a corporate beneficiary, or dividends are paid to the shareholders of the corporate beneficiary to allow the loan repayment to be made (where the shareholders may be subject to tax on those dividends).

The ATO solution (intentional or not) to the need to retain funds in a trust, where only 30% tax has been paid by a corporate beneficiary, is to allow a trustee to hold an amount of a UPE aside on sub-trust, on one of three 'investment options'[5]. Two of those investment options are effectively 7-year or 10-year interest only loans.

In their Practice Statement, the ATO state in relation to both the 7-year and 10-year arrangements that:

> The trustee may, in its capacity as the trustee of the main trust and the sub-trust, decide to put the funds representing the UPE on a [7-year or 10-year] interest only loan between the sub-trust and the main trust.

In their guidance on the requirements for 'investment agreements' the ATO state that the agreement should set out[6]:

> PS LA 2010/4 requires an investment agreement to be legally binding. However, it also states that the document evidencing that legally binding agreement may be prepared as part of the tax return working papers.
>
> The agreement need not be professionally prepared and is not the same as a Division 7A complying loan agreement. You may, however, choose to engage a professional to prepare the agreement where you believe it is appropriate to do so.

[5] Paragraph 58 of PSLA 2010/4

[6] https://www.ato.gov.au/business/private-company-benefits---division-7a-dividends/in-detail/fact-sheets/division-7a---unpaid-present-entitlement/?page=8 retrieved 20 May 2015

> We will consider a document containing the following to be sufficient evidence of a legally binding loan agreement between the main trust and the sub-trust:
>
> a. the names of the parties
>
> b. the loan terms, including
>
> i. the amount of the loan
>
> ii. the date the loan amount is drawn
>
> iii. the requirement to repay the principal amount of the loan
>
> iv. the period of the loan
>
> v. the interest rate payable on the loan
>
> vi. interest payment to be made annually on the last day of the income year
>
> c. that the parties named have agreed to the terms
>
> d. when the agreement was made, for example, the date it was signed or executed.

Care should be taken in drafting such an agreement.

Although the ATO appear to content to refer to the agreement as a 'loan agreement' it may be preferable to style the agreement as something else, such as a 'retention agreement' or 'sub-trust agreement' to avoid the suggestion later that the amount is in fact a loan.

The ATO include in their guidance on what the form of the agreement might be, where in their execution section they say the document should be executed where the corporate beneficiary is referred to as 'Privco':

> Signed by the trustee of the PrivCo Sub-trust and DiscFamily Trust

It appears to be their view, and it is the writer's view, that the agreement should be executed by the trustee of the trust owing the UPE amount, and the trustee of the trust owing the UPE as trustee of the sub-trust for the corporate beneficiary – that is, the document is executed only by the trustee of the main trust, but in two capacities.

The ATO also state that the agreement that is put in place can be an 'ongoing investment agreement' which might otherwise be referred to as a 'facility agreement'.

Experience has shown that it might not be preferable to put in place a facility agreement.

Where there is no investment agreement in place by earlier of the time that the trust return is lodged or due for lodgement, the ATO view is that the UPE becomes a Division 7A loan from the trust to the company. This Division 7A loan can be repaid by the lodgement time for the company tax return for the year in which the loan is made, or it can be brought under a complying Division 7A loan agreement by this time. If a facility agreement is in place, but after the lodgement time for the trust return (for the year in which the UPE is created) passes, the decision is made to pay-out the UPE, there is the need to accrue and pay interest under the sub-trust arrangement. This is not the case

where Division 7A might otherwise apply as you have until the lodgement time for the company return to pay out the 'loan' without having an obligation to pay interest.

It can be observed however that in many cases there is no problem in paying the interest agreed under the sub-trust arrangement if the distribution of the income (sheltered by the interest) would otherwise have been distributed to the company. That is, there is effectively no difference between a deductible interest payment to a corporate beneficiary and a distribution of income to that corporate beneficiary (and there may be a saving in tax under subsection 98(3) if there is interest paid to a non-resident corporation).

4 UPEs and section 100A

In July 2014 the ATO released a factsheet regarding the application of section 100A concerning 'reimbursement agreements'[7].

4.1 Summary of ATO factsheet

The ATO considers that a reimbursement agreement generally involves making someone presently entitled to distributable income of a trust in circumstances where both:

- someone else actually benefits from that income, and
- a purpose of a party to the agreement is obtaining a tax benefit.

However, the ATO notes that arrangements involving 'ordinary family or commercial dealings' are excluded from the definition of a reimbursement agreement.

The ATO quite correctly point out that there is no definition of an ordinary family or commercial dealing. The ATO do however note that they will not consider an agreement to be part of an ordinary family dealing merely because all parties are part of the same family group.

Where section 100A applies the beneficiary that would otherwise be taken to be presently entitled to income is taken not to be so entitled, with the consequence that no-one is taken to be presently entitled to that share of trust income, so that instead the net income referrable to the income is assessable to the trustee at section 99A rates.

The provision does not apply where it is a person under a legal disability (such as a minor) that is presently entitled.

The ATO has an unlimited period of review to apply section 100A.

In the 'Questions and answers' part of the guide the ATO set out their view on the interaction between Division 7A and section 100A, noting that both could apply to an arrangement where there is a loan, payment or forgiveness results in a deemed dividend. They state that where a loan from a trust is put on Division 7A terms, without more, they would consider the loan an ordinary commercial dealing. They also state that the Commissioner will not devote 'compliance resources' to the application of section 100A where amounts are retained a trust for working capital pre-16 December 2009 and will 'not generally seek to devote compliance resources' to considering whether post-16 December 2009 UPEs result in the application of section 100A.

The ATO set out four examples in their facts sheets of where section 100A might not, or might be applied (examples 2 – 4 with example 1 being an example of the operation of the section).

In example 2 the ATO posit an arrangement where a corporate beneficiary is made entitled to income, and the resulting UPE is put under a complying Division 7A loan agreement, or complying sub-trust

[7] https://www.ato.gov.au/General/Trusts/In-detail/Technical-issues/Trust-taxation---reimbursement-agreement/

arrangement. The funds are retained in the trust to allow the trustee to use the funds as working capital for a business. The ATO state they would not consider this arrangement (in the absence of other factors) to be a reimbursement agreement.

Example 3 concerns a testamentary trust where income is to be accumulated for the benefit of, but not paid to, one beneficiary. The ATO accept that such an arrangement, without more, even if the beneficiary is an adult, would not result in a reimbursement agreement.

Example 4 involves a discretionary trust controlled by one beneficiary distributing money to other resident beneficiaries, but only paying enough money to them to fund the tax and retaining the balance in the trust. After several years the trustee makes a loan on commercial terms to the controller of the trust, where principal and interest is payable. The ATO again say that, without more, there would be no reimbursement agreement.

Example 5 is of the 'perpetual motion machine' where a trustee distributes to a corporate beneficiary in which it owns all of the shares. The UPE from year one is discharged by way of set-off against a dividend which gets declared by the company to the trustee in year 2 before the UPE can become a loan. That dividend is then distributed back to the company and the process is repeated.

4.2 Comments

As has been said by other commentators, the problem with the ATO fact sheet, as with much guidance from the ATO, the examples are at either end of the spectrum, providing no guidance on the cases that might fall in the middle.

In a 'Lets Talk Tax' Live Chat, a transcript of which is available on the ATO website[8] Assistant Deputy Commissioner Bruce Collins and Deputy Commissioner Tim Dyce were recorded as saying:

> We recently issued the Fact Sheet on section 100A, which we developed in a co-design process with the tax profession. We are getting some requests for further guidance, but our ability to provide such guidance is limited, given the fact-specific nature of section 100A. We are looking particularly at questions around the exclusion for 'ordinary family or commercial dealings', so there may be scope for litigation on these type of issues at some point.

It is the 'ordinary family or commercial dealings' exception that is of most interest in understanding the ATO position on section 100A. Technically, the expression is of interest because a reimbursement agreement is defined in subsection 100A(7) as being an 'agreement, whether entered into before or after the commencement of this section, that provides for the payment of money or the transfer of property to, or the provision of services or other benefits for, a person or persons other than the beneficiary or the beneficiary and another person or other persons.' The term 'agreement' is then defined in subsection 100A(13) as:

> ***agreement*** means any agreement, arrangement or understanding, whether formal or informal, whether express or implied and whether or not enforceable, or intended to be enforceable, by legal proceedings, but does not include an agreement, arrangement or understanding entered into in the course of ordinary family or commercial dealing.

[8] https://s3-ap-southeast-2.amazonaws.com/ehq-production-australia/59cb9da507a4f584e6a8f65ec352b71d91bb089c/documents/attachments/000/017/979/original/Transcript.pdf?1416440925

The decided cases where section 100A has been applied do not provide much assistance in determining when an ordinary family or commercial dealing will be taken to have occurred.

- In *Raftland Pty Ltd as Trustee of the Raftland Trust v C of T*[9] a loss trust was introduced into a structure and some $2.85 million was distributed to the loss trust, with only some $250,000 being paid as a fee for the acquisition of the loss trust. The dealing was found at first instance not to be a commercial dealing, but the artificiality of the case (with Kirby J considering the arrangements a sham) means not much assistance can be gained in determining what is a commercial dealing.
- From *Idlecroft Pty Limited v Commissioner of Taxation*[10] we learn that for section 100A to apply it is not necessary for the beneficiary to be a party to the reimbursement agreement[11]. In this case, in general terms, Idlecroft Pty Limited was the trustee of a trust that arranged to minimise the tax payable on the income it earned by distributing to a loss company, Westside Commerce Centre Pty Ltd (WCC) as a result of a joint venture agreement that it had entered into with WCC. Only 12% of what was distributed to WCC was paid to it. It was conceded between the parties that the joint venture agreement constituted a 'reimbursement agreement' for the purposes of section 100A. Again because of the contrived nature of the facts, little can be gained from the decision as to what might be an ordinary commercial dealing.
- In *Commissioner of Taxation v Prestige Motors Pty Limited*[12], in broad outline, there was a sale of a business from Prestige Motors to the trustee of a unit trust that was owned in large part by a loss company. Prestige Motors then became the trustee of that trust and it gained control over the foreign entity that had funded the losses. The profits that were previously earned by Prestige Motors would now flow to the loss company unit holder, and the foreign entity as interest on loans. Although the step of paying interest from the unit trust to the foreign entity in this case might have been considered to be an ordinary commercial dealing, 'The question posed by s 100A, especially subs (13), is whether the agreement was entered into in the course of ordinary commercial dealing, not whether a particular element in a transaction implemented pursuant to that agreement could be so characterised.'
- In *Case X40*[13] the tax free amount of $585 (for a non-resident beneficiary) was distributed to 126 non-resident beneficiaries, where the Tribunal member considered the clear understanding was that the amounts would be loaned back to the trustee. Again, nothing of use can be gained from this case in attempting to define an ordinary commercial dealing.

In none of the above cases were the transactions considered to be ordinary family dealings. While the possibility of litigation means that there may be some interpretation of the expression, it is hoped that the ATO might be inclined to consider publishing something on a more 'middle of the road' example.

For instance, if distributions from a family discretionary trust are made to husband and wife equally, but the husband uses most of the funds to pay down personal debt – will that be an ordinary family dealing?

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[9] [2008] HCA 21
[10] [2005] FCAFC 141
[11] Which was reinforced in the first instance in *Raftland*
[12] (1998) 82 FCR 195
[13] 90 ATC 342

If a family discretionary trust distributes amounts to adult children, pays sufficient to the children to fund their tax, and then loans amounts interest free to the parents, would the ATO seek to apply section 100A.

It is submitted that the above two examples, and many like them, occur regularly in the client bases of most practitioners and the ATO's current guidance gives no indication as to what stance the ATO may adopt. Given the open-ended nature of section 100A such lack of clear guidance is frightening.

On the page leading to the transcript records mentioned above, it was stated that what was intended to be talked about in the Live Chat, was:

> The ATO's current issues of concern surrounding scheme arrangements, including:
>
> 1. 99:1 partnerships
> 2. Retirement planning arrangements
> 3. Employment remuneration arrangements
> 4. Property Developers and CGT arrangements
> 5. Trust issues

The first point contains another section 100A issue. While the 99:1 partnership point as not talked about in the chat, it was covered in Senior Tax Counsel Fiona Dillon's presentation at the WA 'Trusts – Current Issues and Hot Topics' presentation in November 2014. Her slide showed:

> 99:1 Partnerships instead of bucket companies
>
> Trust distributes income to a partnership, where Company is 99% partner, individual is 1% partner
>
> 99% of section 97 amount is purportedly only assessed at 30%
>
> Partnership then pays or lends money to the individual or their associate
>
> Commissioner has concerns:
>
> 100A?
>
> Division 7A?
>
> Part IVA?

It would seem that in the above arrangements all of the elements for the operation of section 100A would be present, with the company being party to an arrangement where it will not fully benefit from the distribution of income received. It is also not clear however how the 'partnership' could be a beneficiary of a trust in its own right, given its lack of separate legal existence, making the Commissioner's Division 7A concerns equally evident.

5 The consequences of vesting

There are generally two reasons for a trust vesting:

- The trust is intentionally being brought to an end; or
- The time at which the trust must vest according to its terms has arisen (or passed).

In an intentional vesting, it would be expected that a practitioner would work through what needs to occur legally, and what will occur from a tax perspective, as a result of the trust vesting. Regard would be had, for instance, to the need to dispose of assets, repay or novate liabilities, determine the extent of and satisfy the trustee's right of indemnity, and the need to pass any remaining property to beneficiaries. As well the trustee could consider whether it has a power of appointment over trust capital that it wants to exercise or whether it wants to allow the trust capital to vest in default beneficiaries.

In the case of an intentional vesting of a discretionary trust it could be expected from a tax perspective, that to the extent that assets are passed to a beneficiary that either CGT event A1 or E5 (absolute entitlement) would occur, with the consequence that there could be a gain or loss for the trustee. For the beneficiary, CGT event E5 will not have consequences for them on its own if they acquired their interest in the trust for no consideration. The specific entitlement rules together with the general operation of Division 6 would however likely result in them paying tax on any gain made by the trustee to the exclusion of the trustee. The vesting would have duty consequences only if there is dutiable property in the hands of the trustee that is then the subject of a dutiable transaction such as a transfer. If there was duty paid on the creation of the trust over property and that property or the proceeds of reinvestment from the disposal of such property is passed out in accordance with the terms of the trust there is the potential for duty relief in NSW[14].

If the time at which the trust will vest has been planned for, the result should be much the same as an intentional vesting.

Where the time at which the trust has come and gone, without any planning however, consideration needs to be given to what the consequence of this would be.

If the terms of the trust provided that at the vesting date the trustee would hold property in trust for default beneficiaries, that would be what would have occurred on the vesting date. If the trust instrument did not provide the trustee with any powers past the vesting date, the trustee is unlikely to have any powers beyond administrative ones, or those conveyed by statute, as its obligation under most deeds would be merely to hold the trust property on trust for default beneficiaries. A trustee's fiduciary obligations do not end when the trust ends.[15] The trust would effectively become a fixed trust in favour of the default beneficiaries.

[14] Section 57, *Duties Act 1997* (NSW) provides for only $50 in duty for such a transfer if the CCOSR is satisfied that certain conditions are met.
[15] n 4 above, 37-110

What has now been the subject of multiple papers[16] is that if a trust vests, and there is no actual transfer of property so that CGT event A1 or E5 clearly occur, it will be the case that CGT event A1 does not occur, and CGT event E5 may not occur. There appear to be no other relevant CGT event to consider other than CGT event E5 in working out whether an 'unplanned' vesting will have unforseen tax consequences.

CGT event E5, as mentioned above, occurs when a beneficiary becomes 'absolutely entitled' as against a trustee in relation to a CGT asset. For the trustee there is a capital gain if the market value of the asset is more than its cost base, and there is a capital loss if the market value is less than the asset's reduced cost base. Any gain or loss is disregarded if the asset is a pre-CGT asset. A beneficiary makes a capital gain or loss if the market value of the asset is more than the cost base of the beneficiary's interest in the trust capital to the extent it relates to the asset, and can make a capital loss on the same basis. If the beneficiary paid no consideration for their interest, acquired their interest pre-CGT of if the capital gain or loss for the trustee could be disregarded under the rules applying to special disability trusts and main residences, then the beneficiary disregards the capital gain.

For CGT event E5 to apply at all, there must be absolute entitlement. The ATO set out their preliminary views on the meaning of this term some time ago, in TR 2004/D25. They have never finalised that view. Their view, which can be relied upon as protection against penalties only, is that a beneficiary cannot be absolutely entitled as against a trustee in relation to a particular asset if more than one beneficiary has an interest in that asset. Thus, ordinarily, if there is more than one default beneficiary, on the ATO's view CGT event E5 will not occur because no one beneficiary would become absolutely entitled to an asset on the vesting date. The ATO depart from this view though where the assets of the trust are fungible and:

> the beneficiary is entitled against the trustee to have their interest in those assets satisfied by a distribution or allocation in their favour of a specific number of them; and
>
> there is a very clear understanding on the part of all the relevant parties that the beneficiary is entitled, to the exclusion of the other beneficiaries, to that specific number of the trust's assets.

On the basis of the ATO's draft views, on an unplanned vesting, while their may be assets that are both fungible and divisible, unless there is a clear understanding between the beneficiaries as to who is entitled to what, there will be no absolute entitlement and so no trigger for CGT event E5. In an unplanned vesting it is hard to conceive of how there could be such a clear understanding except in the most unusual of circumstances, say where there was an agreement between the default beneficiaries before the trust vested.

As well as it being the Commissioner's view that there is unlikely to be absolute entitlement, the decisions in *CPT Custodian*[17], and in *Oswal*[18] mean that on the current state of the law, it should be

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[16] See for instance Professor Gordon Cooper's 'A trust primer: Beyond the usual issues' NSW Tax Symposium, October 2014 or Michael Butler's 'Vesting Trust Deeds' from the 30th National Convention 2015, amongst others.

[17] *CPT Custodian Pty Ltd v Commissioner of State Revenue* [2005] HCA 53 concerning a trustee's right of indemnity

[18] *Oswal v Commissioner of Taxation* [2013] FCA 745 concerning a power of sale preventing E5 from occurring and a right of lien also preventing absolute entitlement

possible in most cases to conclude that absolute entitlement does not occur merely because the vesting date has passed.

6 Disclaimers and renouncing trust interests

If a beneficiary in receipt of an appointment of income or capital disclaims that appointment, they will be taken not to have received that 'gift' and so will not be exposed to the tax consequences of the receipt.[19]

That a specific appointment can be rejected by a beneficiary was confirmed in *Commissioner of Taxation of the Commonwealth of Australia v Ramsden*[20] where it was said by the Full Federal Court, in denying the Commissioner's argument that an appointment could not be rejected for one year, if an appointment had been accepted in an earlier year (at para 36):

> When, and if, a gift is made under cl 3(b)(i) or 4, it is consistent with principle that the Specified Beneficiary should be entitled to accept or reject the subject matter of that gift, because a person cannot be forced to accept a gift of property unwillingly. The subject matter of a gift under cl 3(b)(i) is the net income of the trust for a particular Accounting Period. The subject matter of a gift made under cl 4 on the vesting day is the corpus of the Trust Fund. There is no reason in principle why a Specified Beneficiary should lose his or her entitlement to disclaim a particular gift merely because he or she has accepted some other gift from the Trustee in the past although acceptance of the earlier gift may have relevance to the question whether that person had knowledge of his or her interest in the Trust under which the latter gift was obtained and to whether the reasonable time had elapsed within which that person could disclaim that interest. If and when gifts are made pursuant to these clauses or as a result of the operation of these clauses, they are independent gifts, and a donee may accept one or more of the gifts and disclaim the benefit of the interest under another clause or clauses: Theobald on Wills 16th Ed at 14-25, and this is so whether or not the respective interests are vested interests.

In relation to an interest as a taker in default, the Full Federal Court did not consider that a disclaimer could operate on the default entitlements of one year only (at para 42):

> The subject matter of a cl 3(e) gift is income arising in each accounting period not the subject of a cl 3(b) appointment. To be effective, a disclaimer must extend to the whole of that subject matter, hence a disclaimer confined to one only of those accounting periods is necessarily ineffective.

The effect of the disclaimer was set out by the Full Court in *Ramsden* (at para 30):

> Until disclaimer, a beneficiary's entitlement to income under a trust is operative for the purposes of s 97 of ITAA from the moment it arises notwithstanding that the beneficiary has no knowledge of it (Federal Commissioner of Taxation v Vegners (1989) 89 ATC 5274; (1991) 91 ATC 4213 at 4215). A beneficiary may disclaim an entitlement on its coming to his or her knowledge. **At law an effective disclaimer operates retrospectively, and not merely from the time of disclaimer**. (emphasis added)

Thus, an effective disclaimer will operate to effectively cancel any original entitlement so that that entitlement never existed. Who then benefits from that entitlement will depend upon the trust instrument and the terms of any appointment affected by the disclaimer.

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[19] A fuller discussion of disclaimers can be found in Andrew Mills' paper 'Trust Update – What the ATO thinks and why you should care' from the 46th Western Australian Convention

[20] [2005] FCAFC 39

Regarding the time at which a disclaimer must be made it was said by Spender J when *Ramsden* was before him:

> 80 The applicant at no stage, in my judgment, has accepted the interest. The various disclaimers constitute an absolute rejection of the distribution to her as a Specified Beneficiary in default of appointment of income by the Trustee. The notice of objection is consistent only with her contention that there was no interest in her in any part of the $429,000 that had been appointed to the Adcock Trust. A beneficiary will be taken to have accepted the interest where the beneficiary is made aware of it and does not, before a reasonable time has elapsed, seek to disclaim it: *Hodge v Griffiths* [1940] 1 Ch 260. The act of disclaimer must, usually, occur before any act constituting assent to the distribution. At all times the applicant has disputed that she had any entitlement to any part of the $429,000, and in my judgment she has at no time done any act signifying assent to the distribution to her.

The ATO have considered when a disclaimer needs to be made in relation to a life or remainder interest in TR 2006/14, which expands only slightly on the timing, but also signifies that the ATO consider that the interest effectively never existed if the disclaimer is effective and that there is no CGT event that occurs:

> 29. No CGT event happens to a life interest or remainder owner in respect of the effective disclaimer of their interest.
>
> 30. An effective disclaimer must be intentional and show unequivocally that the nominated life or remainder owner rejects their interest. The right to disclaim is lost if that person has engaged in positive conduct indicating an acceptance of their interest. The right may also be lost if it is not exercised within a reasonable time, in that someone who remains silent beyond the time when they may be expected to disclaim the interest may be presumed to have accepted it. If a life or remainder owner effectively disclaims their interest, they are retrospectively disentitled to it.

That there is no CGT event is consistent with an effective disclaimer operating to retrospectively from creating any asset in the beneficiary.

To be effective a disclaimer does not need to occur by deed, ' … any evidence of actual dissent is sufficient'[21].

Where it is not possible to disclaim an interest, it is possible to renounce the interest. Such a renunciation will however have potential tax consequences. In 2001 in relation to renunciations the ATO stated in TD 2001/26:

> A renunciation by a beneficiary of an interest in a discretionary trust (the interest being a CGT asset) would give rise to CGT event C2 for the beneficiary because it is an abandonment, surrender or forfeiture of the interest (section 104-25 of the *Income Tax Assessment Act 1997* ('ITAA 1997')).

The context of the TD was that at the time, changes to Social Security legislation were making it necessary for some beneficiaries to renounce their interests in order to prevent the assets and income of the trust from being counted for income and asset test purposes, and so affecting their pension entitlements.

The ATO in the TD do recognise that the renunciation of the interest of a mere object for no consideration is likely to have no tax consequences as '… the market value of the interest at the time of the renunciation would generally be nil.'[22]

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[21] *Federal Commissioner of Taxation v. Cornell* 73 CLR 394

In relation to the renunciation of the interests of a taker in default the ATO, reasonably, say that the interest may have value and that its value would be influenced by:

> the terms of the particular trust and its purpose, the past history of distributions made by the trustee in favour of the default beneficiary and all the other circumstances of the particular case.

The value of the interest of a taker in default of capital would also need to take into account the present value of the interest to calculate whether there is a gain on renunciation.

[22] TD 2001/26, para 2

7 Changing the trust relationship and resettlements

The ATO Statement of Principles, which until 20 April 2012 provided guidance on the ATO view as to whether changes to a trust relationship might about to a resettlement (the creation of a new trust) was quite restrictive. Much was written over the years since its publication in 1999, criticising the legal reasoning and the conclusions set out in it.

It was withdrawn on 20 April 2012 following the decision in *Federal Commissioner of Taxation v. Clark and Anor*[23] and the High Court's refusal to grant the Commissioner leave to appeal that decision.

In *Clark* in the 2001 income year, Clark Enterprises Pty Ltd ('CEPL') as trustee of the Carringbush Unit Trust ('CU Trust') sold two properties in Gladstone realising a net capital gain of $1,932,006.

The trustee sought to offset carried forward capital losses against the capital gain. The capital losses resulted primarily from a share sale in 1993 realising a loss of $2,492,653 and the writing off of a debt in 1991 of $375,995.

The Commissioner in that case argued before the Federal Court that changes to the trust in:

> June 1993 that had the effect of changing the trustee of the CU Trust, altering the ownership of the units of that trust, extinguishing liabilities of the trust, extinguishing the former trustee's right of indemnity out of trust assets, altering the corpus of the trust, and changing the activity of the trust from a dormant trust to a vehicle used by Mr David Clark to take advantage of accumulated losses in the CU Trust to offset profit in the Enterprises Trust by causing Clark Enterprises as the trustee of the Enterprises Trust to distribute $1,965,000.00 to CEPL as trustee of the CU Trust as a beneficiary of the Enterprises Trust.

The reason for the changes in 1993 were that Mr Clark, the controller of CEPL, agreed with the existing controller of the CU Trust, a Mr Denoon, to use the CU Trust as a joint venture vehicle through which to undertake property development activities. Both gentlemen were candid in their testimony that they were motivated to use the CU Trust through a desire to take advantage of the capital losses in the trust to shelter future profits from property development. The reference to the alteration of the corpus of the trust was a reference to an agreement whereby, until such time as Mr Denoon or his entities had matched a capital contribution of some $1.8 million made by Mr Clark, he would not participate in the $1.8 million capital or the income earned from the capital.

The Federal Court had referred to the High Court decision in *Commercial Nominees*[24] where three tests were set out as to whether there was continuity for the purposes of Part IX (then the superannuation fund taxing regime):

> The three main indicia of continuity for the purposes of Part IX are the constitution of the trusts under which the fund (if a trust fund) operated, the trust property, and membership.

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[23] [2011] FCAFC 5

[24] *Federal Commissioner of Taxation v Commercial Nominees of Australia Ltd* (2001) 75 ALJR 1172

The Commissioner argued four points to prove discontinuity of trust estate. First, that the trustee's waiver of its right to be indemnified out of the trust effectively created a new trust. Second, that the right to income of the trust ceased to be governed by the terms of the trust deed, due to the deed between the Clark and Denoon interests. Third, there was a significant change in the trust property. And fourth, that there was a completely new set of unit holders in place at the time when the losses were recouped.

The Court dealt with each point in turn. In respect of the first point, the Court found that the trustee's waiver of its right to indemnity extinguished a 'beneficial interest' in the trust assets, at most. The waiver of the right did not alter the terms of the Deed.

The deed between the Clark and Denoon interests was found to be in relation to the exercise of the rights under the Deed, not a variation of the rights under the deed. These arrangements did not vary the trust, 'let alone terminate them or bring a new trust into existence'.

The Court found that the trust property was expected to change as was the identity of the beneficiaries, as this was part of the usual operation of a trust fund, and did not affect the continuity of the fund. The High Court decision in *Commercial Nominees* was relied upon in support of this conclusion. *Commercial Nominees* should be read to support the view 'that there had to be a continuum of property and membership, which could be identified at any time, even if different from time to time; and without severance of one or both leading to the termination of the trust in question.'

The ATO after *Clark* issued TD 2012/21 which sets out the current ATO that changes to a trust that fall short of a termination of the existing trust, or the creation of a new charter of rights and obligations over particular assets will not trigger CGT events E1 or E2.

The examples in the draft determination of changes that would not amount to a resettlement are:

- Using a power of amendment to remove or add beneficiaries;
- Changing a trustee's investment powers to allow investment in land;
- Changing the definition of income and adding a streaming power and extending the vesting date.

The example of the creation of a new charter of rights and obligations so that there would be a resettlement involves a trustee amending a trust deed that it will hold a particular asset on trust for only one beneficiary. This example does not involve a termination, instead it is the creation of a new trust.

7.1 Impact on renunciations and disclaimers

It is not uncommon in family law cases for the parties to require that one of the couple not only renounce or disclaim their interest in the trust (as discussed above), but also that they are removed as an object of the trust. It is clear following *Clark* that the removal of a discretionary object or taker in default, will not result in a resettlement for income tax purposes without that removal in fact terminating the trust relationship, which it is unlikely to do. The position in relation to duty is equally clear, with the OSR's ruling DUT 017 (which it is acknowledged is not binding on them) provides that unless a variation is or includes a declaration of trust:

16. The following variations to discretionary trusts are not dutiable transactions over dutiable property, and will not be liable to duty:

a. a variation that adds a beneficiary to, or deletes a beneficiary from, the class of persons who are takers in default;

b. a variation that adds a beneficiary to, or deletes a beneficiary from, the class of persons who are discretionary objects;

c. a variation that varies the interests inter se of beneficiaries without altering the identity of beneficiaries; and

d. a variation that merely inserts or amends administrative powers without affecting the interests (if any) of the beneficiaries in the trust property.

8 Trusts mischaracterising receipts

In July 2014 the ATO issued a Taxpayer Alert entitled 'Trusts mischaracterising property development receipts as capital gains'. In the press this was publicised as the ATO 'cracking down' on property developers. The Taxpayer Alert describes an arrangement where property developers use trusts to return the proceeds from property development as capital gains instead of income on revenue account. The arrangements are described as ex
lowing characteristics
(taken directly from TA):

> An entity with experience in either developing or selling property, or in the property and construction industry, establishes a new trust for the purpose of acquiring property for development and sale.
>
> In some cases the trust deed may expressly state that the purpose of the trust is to hold the developed property as a capital asset to generate rental income. In other cases the trust deed may be silent as to its purpose.
>
> Activity is then undertaken in a manner which is at odds with the stated purpose of treating the developed property as a capital asset. For example:
>
> > Documents prepared in connection with obtaining finance for the development may indicate that the dwellings constructed on the land are to be sold within a certain timeframe and that the proceeds are to be used to repay the loan.
> >
> > Communication with local government authorities overseeing building approvals may describe the activity as being the development of property for sale.
> >
> > Real estate agents may be engaged early in the development process, and advertising to the general public may indicate that the dwellings/subdivided blocks of land are available to be purchased well in advance of the project's completion, including sales off the plan.
>
> The property is sold soon after completion of the development, where the underlying property may have been held for as little as 13 months.
>
> The trustee treats the sale proceeds as being on capital account, and because the trustee acquired the underlying property more than 12 months before the sale, it claims the general 50% capital gains tax discount (in other words, it treats the gain/profit in respect of each sale as a discounted capital gain).

The issues the ATO say arise include:

> Whether the underlying property constitutes trading stock on the basis that the trustee is carrying on a business of property development,
>
> Whether the gross proceeds from sale constitute ordinary income on the basis that the trustee is carrying on a business of property development,
>
> Whether the net profit from sale is ordinary income on the basis that, although the trustee is not carrying on a business of property development, it is nevertheless involved in a profit making undertaking.

The ATO says that they have commenced a number of audits and made adjustments to increase the net income of a number of trusts and that audit activity will continue.

In the transcript of a live chat available on the ATO website[25] Bruce Collins and Tim Dyce were recorded as saying:

> On the arrangements we are seeing involving property developers using special purpose vehicle trusts to run each property development separately, so that they can claim to be investing on capital account and access the CGT 50% discount and even the small business CGT concession. We recently issued a Taxpayer Alert on these sort of arrangements and have a compliance program running at the moment.

and

> … on the property developer issue, we have identified several hundred taxpayer groups who seem to be involved in such arrangements, with between $100M and $200M in potential adjustments (by re- characterising the receipts as revenue).

8.1 Comments

The ATO attack on these arrangements is not hard to understand. They have presumably focussed on the use of trusts rather than individuals or companies, as a new trust can be established for each new venture (as compared to undertaking multiple developments in an individuals name) and as companies do not benefit from the CGT general discount. The ability to use a new trust for each venture allows a taxpayer to disguise the level of property development activity.

If the gain made is in fact on revenue account, whether as a result of the disposal of trading stock, or merely because the asset was acquired for the purposes of resale[26] then any capital gain made would be disregarded because of the operation of section 118-20 of ITAA1997.

The Courts have been prepared to look beyond the history of the entity concerned in determining whether the intention of acquiring land was to hold it to derive income from it otherwise than on sale (e.g. rent) or to hold it for the purpose of sale. For example:

- In *August v Commissioner of Taxation*[27] the Court considered the behavior of one of the participants in the property transactions, a developer by the name of Spiros (Jeff) Konstantinou, in determining the purpose of the acquisition of property.
- In *R & D Holdings Pty Ltd v Deputy Commissioner of Taxation*[28] the Court took into account the past history of property development for resale by the controller of the company, Mr Richardson, through other vehicles.

If a trust is to acquire land to be used for a purpose other than resale, or development and sale, then it is important, as the ATO highlight, that as well as the parties stating that they are holding the land as a capital asset, that their actions in relation to finance, development approval and advertising are consist with holding a capital asset.

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[25] http://lets-talk.ato.gov.au/live-chats/documents/17979/download retrieved 19 May 2015
[26] *Westfield Ltd v Federal Commissioner of Taxation* (1990) 21 ATR 784
[27] [2012] FCA 682
[28] [2006] FCA 981

9 Time limits on raising trustee assessments

In December 2004 Government released the Treasury 'Report on Aspects of Income Tax Self Assessment'[29]. A recommendation of that report was that there be a limited period of time for the ATO to amend an assessment showing a nil liability (recommendation 3.4).

In the *Tax Laws Amendment (Improvements to Self Assessment) Act (No. 2) 2005* the definition of assessment was amended to include (relevantly to discretionary trust trustees):

> (d) for any other taxpayer that is the trustee of a trust estate but excluding a taxpayer that is the trustee of a fund or unit trust referred to in paragraph (a), (b) or (c) of the definition of **eligible entity** in subsection 267(1) - the ascertainment of so much of the net income of the trust estate as is net income in respect of which the trustee is liable to pay tax (or that there is no net income in respect of which the trustee is so liable) and of the tax payable on that net income (or that no tax is payable)

In 2005 the reference to eligible entity was a reference to eligible ADFs, superannuation funds and PSTs.

Currently the definition of assessment includes:

> (d) for a taxpayer that is the trustee of a trust estate (other than a trustee to which paragraph (b) or (c) applies or the trustee of a complying superannuation fund, a non-complying superannuation fund, a complying approved deposit fund, a non-complying approved deposit fund or a pooled superannuation trust)--the ascertainment:
>
> (i) of so much of the net income of the trust estate as is net income in respect of which the trustee is liable to pay tax (or that there is no net income in respect of which the trustee is so liable); and
>
> (ii) of the tax payable on that net income (or that no tax is payable); and
>
> (iii) of the total of a taxpayer's tax offset refunds for a year of income (or that the taxpayer can get no such refunds for the year of income);

The definition of an assessment would appear to include what occurs when the Commissioner determines that there is no tax payable by the trustee on the net income of a trust estate following lodgement of the return.

Despite there being an 'assessment' when the Commissioner determines there is no tax payable by a trustee, the provisions dealing with amendment of assessments rely on counting from the time that the Commissioner 'gives notice of the assessment…'. It is not the Commissioner's practice to issue assessments to trustees when returns are lodged, so that the time limits in subsection 170(1) of ITAA1936 cannot begin to run[30].

The ATO issued Practice Statement Law Administration *PS LA 2015/2* in February 2015 which guides ATO staff to limit the time within which they will issue an assessment to the trustee of a trust, to ensure that trustees are subject to, broadly, a similar period of review as other taxpayers. The ATO

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[29] http://selfassessment.treasury.gov.au/content/report.asp - retrieved 19 May 2015

[30] PSLA 2015/2 paragraph 1

refer to such an assessment as an 'original' assessment, presumably because they have not chosen previously to issue an assessment, though technically it would seem that the original assessment occurs when the Commissioner determines the liability of the trustee, not when he gives an assessment to the trustee.

The net income of a trust is ordinarily assessed to the beneficiaries. A trustee may, however, be issued with an assessment and taxed in certain instances, for example in respect of a non-resident beneficiary or where no beneficiary is presently entitled to the trust's income.

The ATO considers that them having an unlimited time to review the assessment made when the return is lodged is inconsistent with the outcome contemplated by the *Report Aspects of Income Tax Self Assessment,* that all taxpayers returning a nil liability should have a limited period of review.

Accordingly, the ATO states that its practice will be to limit the review period for trustees to the following time periods:

- four years after the relevant trust tax return was lodged; or
- two years after lodgment of a return for the 2014 or a later income year, if the trust is a small business entity for that year and none of the qualifications in item 3 of the table in subsection 170(1) apply.

The ATO states that the exceptions, where the above time limits will not apply, are where:

- the trustee has not lodged a trust return for the relevant income year;
- the Commissioner is of the opinion that there has been fraud or evasion;
- an extended or unlimited amendment period would apply; or
- the time limit has been extended by agreement with the trustee.

The ATO states that the time limit may be extended by way of agreement with the trustee, if the ATO has started examining the affairs of a trust and it is not reasonably practicable for it to ascertain that the trustee is liable to tax within the above time limits because of actions taken or statements made, or unreasonable omissions, by the trustee or a related entity. In this case, the ATO advises that the matter should be escalated to an SES officer who, in consultation with the trustee, should determine the period within which an assessment is to be raised.

The following examples, of the application of the above time limits and exceptions, are included in the Practice Statement.

> Example 1 - time limit for raising an original trustee assessment
>
> The 2010 income tax return for the Oak Family Trust was lodged on 9 May 2011. The trust was not a small business entity for the 2010 income year. An audit of the trust reveals that some of the trust net income should be assessed to the trustee under section 99A. The time limit for review has not been extended by agreement with the trustee. An assessment should be issued to the trustee by 9 May 2015.

Example 2 - multiple trustee assessments

A trust return for the Cedar Family Trust was lodged on 9 May 2011. The trust was not a small business entity for that income year. An assessment is issued to the trustee under section 98 on 30 June 2011. As a result of audit activities, the Commissioner considers the trustee should instead be assessed under section 99A. The time limit for review has not been extended by agreement with the trustee. The section 99A assessment must be made by 9 May 2015 and is an original, not an amended, assessment.

Similarly, if the result of the audit was that the trustee was assessable under section 98 in respect of a different beneficiary, then that assessment should also be issued by 9 May 2015.

Example 3 - time limits do not apply - unlimited amendment period

A beneficiary has been assessed under section 97 on all of the net income of a trust for the 2008 year. As a result of some compliance action taken by the ATO, it was established that the beneficiary's entitlement to trust income arose out of a reimbursement agreement. Consequently the net income is assessable to the trustee under section 100A. Under subsection 170(10) the ATO has an unlimited time to assess a present entitlement arising from reimbursement agreement. Accordingly, there is no time limit for issuing an amended assessment in this instance, however the ATO states that its officers should endeavour to do so as soon as practicable.

Example 4 - extension of time limits

A trust's taxation affairs are being reviewed. However, due to the complexity of the arrangements, the ATO does not expect to complete the review before the end of the abovementioned time limits. The ATO obtains the trustee's agreement to extend the relevant time limit by a further six months. The ATO has until 14 November 2014 to issue a trustee assessment/s (if required), unless it negotiates further time.

Example 5 - extended timeframes

The 2009 return for the Pine Family Trust lodged on 9 May 2010 indicates that all of the net income is assessable to an individual beneficiary. That beneficiary's assessment is issued on 6 June 2010.

On 1 June 2014, the beneficiary requests an amendment on the basis that the trustee's resolution appointing income was invalid. The default beneficiary (a minor) was instead presently entitled to all the income and the trustee should have been assessed under section 98 on all of the net income. The ATO officer should escalate the case to an SES officer who, having regard to all of the facts, will determine in consultation with the trustee a period within which an assessment is to issue.

It is disappointing that the Commissioner has decided to deal with the issue of limiting the time period for amending the assessment of a trustee in this way – by issuing administrative, and therefore non-binding guidance to his officers. The law could operate in the way it is intended to in relation to the assessment the Commissioner makes when determining the liability of a trustee (as defined by the term ‘assessment’ in subsection 6(1) of ITAA1936) if he changed his internal processes so that a nil assessment was issued when a trust return was lodged. A taxpayer could then rely on the law, rather than the decisions of the Commissioner’s officers, to determine whether an assessment issued to a trustee should be amended.

10 Distributions of discountable capital gains to non-residents

There are two issues to be considered in connection with the situation where a resident trust estate makes a foreign resident beneficiary presently entitled to trust income that includes capital gains, or specifically entitled to capital gains. Those issues are related to the tax imposed on the trustee and the beneficiary (streaming issues) and the calculation of the taxable capital gain (discount issues).

10.1 Streaming issues

In June 2011 with effect from 1 July 2010 the streaming measures (discussed above) were introduced.

One of the anomalies introduced by the streaming provisions was the treatment of capital gains distributed to non-residents.

Under the former law it was the case that capital gains on foreign assets were treated as foreign income, and so were not subject to tax in the hands of the trustee (under subsection 98(3) of ITAA 1936 as it works in conjunction with subsection 98(2A)) [31]. A trustee was (and is) required to pay tax where a non-resident beneficiary is presently entitled to a share of the income of the trust estate, and the non-resident beneficiary then has a share of the net income of the trust estate that is attributable to sources in Australia.

The tax position for the trustee changed when the streaming provisions were introduced as, in working out the amount that a trustee is assessed on, any capital gains included in a beneficiary's assessable income under subdivision 115-C are amounts that the trustee must pay tax on under subsection 98(3).

For a foreign resident the position in relation to capital gains also changed for foreign assets (on which foreign sourced capital gains could be made) when the streaming provisions were introduced.

As a foreign resident you are only generally taxable on your Australian sourced income, whether that be ordinary income (subsection 6-5(3)) or statutory income (subsection 6-10(5)). A foreign resident is also taxed on their statutory income that a provision includes in your assessable income on some basis other than the income having a foreign source.

Prior to the streaming provisions a foreign resident generally only had amounts included in their statutory income under subsection 97(1). These amounts included both ordinary income and capital gains.

After the streaming provisions were introduced the capital gains do not get included in foreign resident's assessable income because of subsection 97(1), they are instead included because of

[31] This is accepted by the ATO in ATO ID 2010/54

Subdivision 115-C, without reference to the source of the gains, rendering those gains subject to domestic taxation.

10.2 Discount issues

On 8 May 2012 the law was changed to prevent a non-resident from being able to access the CGT general discount on the disposal of an asset acquired after 8 May 2012.

The rules work rather simply for assets owned directly by non-residents (or temporary residents), that were not residents (and were not temporary residents) on 8 May 2012 and can be summarised as:

- If the asset was acquired prior to 8 May 2012 you get no discount unless you choose to get a market value for the asset as at 8 May 2012;
- If you do obtain a market value for the asset on 8 May 2012 you can benefit from the discount on the gain made up to 8 May 2012 if you so choose.

The provisions dealing with gains made indirectly through discretionary trusts (that is, not fixed trusts) operate similarly in that if the asset was acquired prior to 8 May 2012 you get no discount unless you choose to use a market value for the asset as at 8 May 2012 in working out your capital gain.

The effect of these changes is that you 'look through' the discretion trust and treat the asset as if it were owned by the non-resident.

If a person was a resident of Australia on 8 May 2012 and they own an asset directly, then the provisions operate differently, to deny them the discount to the extent that they were non-residents after 8 May 2012.

The provisions have a similar look through effect for a person resident on 8 May 2012 that benefits from a trust capital gain to deny them the benefit of the discount to the extent that they were non-residents after 8 May 2012.

For beneficiaries of trusts, as is the case for persons owning assets directly, where the beneficiary was a non-resident for the whole period of ownership (as determined on a look-through basis), for any asset where there is an underlying gain as at 8 May 2012 it is going to be preferable that a market value for the asset be chosen on 8 May 2012.

Note that the provisions operate differently if the gain has come through a fixed trust, where there is no look through, and it is the time of the acquisition of the interest in the fixed trust that becomes the time that is compared against whether the pre-8 May 2012 or post-8 May 2012 apportionment rules apply. The focus on the date of acquisition of an interest in a fixed trust also occurs if a capital gain flows through from a fixed trust, to a non-fixed trust, to a beneficiary.