LCG 2015/D8 - Attribution Managed Investment Trusts: the rules for working out trust components - allocation of deductions

Draft Law Companion Guideline

LCG 2015/D8

Attribution Managed Investment Trusts: the rules for working out trust components – allocation of deductions

Relying on this draft Guideline

This draft Law Companion Guideline describes how the Commissioner proposes to apply the law in Tax Laws Amendment (New Tax System for Managed Investment Trusts) Bill 2015 when it comes into effect. If you rely on this draft Guideline in good faith before it is finalised, and the law is enacted as introduced, you will not have to pay any underpaid tax, penalties or interest in respect of matters it covers if it does not correctly state how a relevant provision applies to you.

Table of Contents	**Paragraph**

What this draft Guideline is about

1. Broadly, under the attribution regime, amounts of assessable income (net of deductions) retain the tax character they had for an attribution managed investment trust (AMIT)[1] after they have been attributed to its members. This draft Guideline discusses the legislative rule for allocating deductions between amounts of assessable income with different tax characters (such as capital gains or franked distributions) in the hands of the AMIT, to work out the net amount of each type of assessable income with a specific tax character. It is these amounts (the 'trust components' of particular characters) that will be eventually attributed to the member.

Date of effect

2. It is proposed that this draft Guideline will be finalised as a public ruling, effective for those who rely on it in good faith from when the Tax Laws Amendment (New Tax System for Managed Investment Trusts) Bill 2015 (the Bill) comes into effect. If the Bill is enacted as introduced, this will be for assessments for income years starting on or after:

- 1 July 2016, or
- if the trustee has made an irrevocable choice to apply the new tax system for its 2015-16 income year which starts on or after 1 July 2015 – 1 July 2015.

Subdivision 276-E – Trust components

3. To attribute amounts of a particular character to members for an income year, Subdivision 276-E requires the AMIT to first determine the total net amount of that character in its own hands (that is, at the trust level). Such a net amount of a particular character is known as a 'trust component'.

4. The general rules for calculating trust components include:

- Assume that the trustee was a resident taxpayer and was liable to pay tax in that capacity.
- The sum of all of the trust components of various assessable income characters (such as components having the character of capital gains, franked distributions and other income) must equal the total assessable income of the AMIT, less all of its allowable deductions.
- In circumstances where deductions exceed total assessable income and the AMIT makes a tax loss, the trust component of each assessable income character for the income year is nil.

5. Section 276-270 outlines the deduction allocation rules for working out the trust components of various assessable income characters (character pools).

Section 276-270

6. Broadly, there are two steps for allocating allowable deductions against assessable income under section 276-270:

Step 1: Allocate direct deductions against a particular income character

- The AMIT needs to determine whether a deduction relates directly to income of a particular character. This must be determined on a reasonable basis. For example,

[1] An AMIT is a managed investment trust that has elected in to the attribution regime for the taxation of MITs contained in Division 276 of the *Income Tax Assessment Act 1997*. All legislative references in this draft Guideline are to the *Income Tax Assessment Act 1997* as proposed to be amended by the Tax Laws Amendment (New Tax System for Managed Investment Trusts) Bill 2015, unless context otherwise dictates.

a deductible expense relates directly to assessable income of a particular character where it is incurred in the course of deriving that assessable income.

- Where the AMIT reasonably determines that a deduction relates directly to only one particular income character, it must apply that deduction against that amount of income only.
- An AMIT must apply a deduction that relates directly to separate amounts of assessable income with different tax characters against these amounts on a reasonable basis.

Step 2: Allocate other deductions

- After the AMIT has allocated deductions directly related to income, it must apportion any part of these deductions still remaining (for example, if there is insufficient income to which the deduction directly relates) and any other deductions between the remaining amounts of assessable income on a reasonable basis. Common examples of other deductions include general expenses relating to the day-to-day operation of the AMIT, such as management fees and accounting expenses. These are not incurred in deriving assessable income of any particular character, but are incurred in the course of deriving the assessable income of the AMIT in general.

7. The allocation rule applies to multi-class AMITs in the same manner as it does for single class AMITs. Deductions that relate directly to the income of a particular character for a particular class of member only should be allocated to income of that character from that class alone. Deductions that relate to more than one class of member should be allocated among those classes, and among the relevant particular character types within each class on a reasonable basis.

8. The allocation rule in section 276-270 is broadly consistent with the principles for allocating amounts between assessable and exempt income explained by the High Court in *Ronpibon Tin NL v. FC of T*.[2] In this case, the High Court laid down a ‘fair and reasonable’ requirement for apportioning expenses between assessable and exempt income under the predecessor of section 8-1 (former subsection 51(1) of the *Income Tax Assessment Act 1936* (ITAA 1936)).

Reasonable apportionment of expenses

9. The concept of ‘reasonable basis’ is relevant at both Steps 1 and 2 under section 276-270. In Step 1, the AMIT must determine on a ‘reasonable basis’ whether a deduction relates directly to an amount of assessable income, and in Steps 1 and 2 they must allocate deductions related to more than one income character against the amounts of those character pools on a ‘reasonable basis’.

10. The Explanatory Memorandum to the Bill lists, in paragraph 3.35, the following factors as being relevant to determining whether the allocation of a deduction is 'reasonable':

- whether the deduction was incurred in the course of deriving a particular amount of assessable income
- whether the deduction is factored into the financial risk management of the assets from which the particular amount of assessable income arises
- whether the deduction more directly relates to other amounts of assessable income, and
- whether the trustee uses a consistent methodology for allocating deductions to amounts of assessable income.

11. Relevant dictionary definitions of ‘reasonable’ include ‘not exceeding the limit prescribed by reason; not excessive’. Therefore, by specifying that the allocation must be on a ‘reasonable basis’, the legislation does not prescribe a specific approach to allocating deductions across characters, such as a specific ordering rule, or requiring that a rateable approach be applied. That is, what is a ‘reasonable’ approach depends on the facts and circumstances of each case.

[2] (1949) 78 CLR 47.

12. In addition to the matters identified in the Explanatory Memorandum (see paragraph 10 of this draft Guideline), the following factors indicate that an allocation is reasonable:

- the allocation for tax purposes is consistent with the underlying allocation under general trust law of trust income and expenses used to calculate members' entitlements to each component
- the allocation method has been applied consistently by the AMIT from year to year, and
- the deductions have not been allocated merely to bring about the most beneficial after-tax outcomes for members, but are otherwise explicable commercially or under general trust law.

13. While the concept of 'reasonable basis' is relatively broad, it is not without limits. For example, the use of different ordering rules in each year, or alternating between an ordering rule and a rateable approach (without a justifiable commercial basis for that particular year), would not ordinarily constitute a reasonable basis. Unless there is a genuine reason to change, AMITs should apportion their deductions consistently from year to year. A genuine reason for change may include a change in custodian (or outsourcing to a custodian) where the custodian applies a different expense allocation methodology.

14. The following examples outline circumstances where we would consider the allocations to be made on a 'reasonable basis' under section 276-270.

Example 1: Directly related deduction (Step 1 – subsection 276-270(3))

15. *An AMIT borrows money to acquire shares (deriving franked and unfranked dividends) and a rental property (deriving rental income). Under subsection 276-270(3), the AMIT must determine on a reasonable basis whether the deductible interest expense relates directly to the dividends, to the rental income, or to both. This generally depends on whether you can trace the use of the borrowed funds to the initial investment in the shares and rental property respectively. If the funds can be traced separately to the initial investment in each class of asset, the interest attributable to the funds invested in the shares relates directly to the dividend income, and interest attributable to the funds invested in the property relates directly to the rental income.*

16. *If, on the other hand, the borrowed funds were used to acquire units in a managed fund from which the AMIT derived dividends, interest, rent and capital gains, the interest expense would relate directly to more than one amount of income. Accordingly, the AMIT would allocate the interest expense against the amounts of assessable income on a reasonable basis (such as, for example, rateably).*

Example 2: Allocation of general expenses on an ordering basis

17. *An AMIT has investments in Australian equities (shares and units) from which it derives dividends (franked and unfranked), interest and capital gains. The AMIT has general deductions relating to its day-to-day operations, such as management fees and accounting expenses, which are not incurred in deriving assessable income of any particular character.*

18. *It would be reasonable for an AMIT to allocate general deductions against its net capital gain only after it has allocated them against assessable income of other characters where it has consistently maintained this policy from year to year. This is consistent with Example 3.1 in Chapter 3 of the Explanatory Memorandum. Note that section 51AAA of the ITAA 1936 would not apply to preclude general deductions being allocated to net capital gains on a residual basis.*

19. *An AMIT could take a similar approach to franking credit gross up amounts in respect of franked dividends. If the AMIT maintained the policy from year to year, it would be reasonable for it to allocate general deductions against the assessable gross-up amount only after assessable income of other characters has been exhausted.*

20. *In both cases, the allocation is broadly consistent with the deduction allocation rules implicit in the way Subdivisions 115-C and 207-B would have formerly applied to the AMIT that elected to apply the rules.*

Example 3: Allocation of general expenses on an ordering basis – adding capital gains to trust capital

21. *An AMIT has investments in Australian equities (shares and units) from which it derives dividends (franked and unfranked), interest and capital gains. The AMIT has general deductions relating to its day-to-day operations, such as management fees and accounting expenses, which are not incurred in deriving assessable income of any particular character.*

22. *The AMIT issues both income units and capital units. It has a policy of adding capital gains to trust capital while dividends, interest and trust distributions, less expenses, are treated as its distributable income. The AMIT also has a policy of meeting the general expenses referred to in paragraph 21 of this draft Guideline from income rather than capital.*

23. *This expense allocation policy:*

- *is consistent with the terms of the trust*
- *has been applied consistently from year to year, and*
- *is taken into account in working out the entitlements of the holders of income units.*

The related income tax deductions are similarly applied to this income in working out the relevant trust components.

24. *We consider this allocation of deductions to be reasonable.*

Example 4: Rateable apportionment of general expenses

25. *Assume the same facts as Example 2, except that the AMIT's assessable income has the following sources:*

- *50% from dividends (including franking credit gross up)*
- *20% from interest, and*
- *30% from capital gains.*

26. *The AMIT allocates general expenses on a rateable basis consistently from year to year. This broadly means that they allocate the general expenses in the same proportions as the assessable income.*

27. *Provided it is applied consistently from year to year, we consider this rateable allocation method to be reasonable.*

Example 5: Non-rateable apportionment of general expenses

28. *The AMIT derives dividends, interest and capital gains. It has general deductions relating to its day-to-day operations, such as management fees and accounting expenses that are not incurred in deriving assessable income of any particular character.*

29. *The AMIT allocates general expenses on a non-rateable basis consistently from year to year. This means that they allocate the general expenses in the same proportions to each character pool, that is, one-third to each of the three characters.*

30. *Provided it is applied consistently from year to year, we consider the non-rateable allocation method to be reasonable.*

Example 6: Allocation of general expenses of a multi class trust in proportion to income characters of each class

31. *Assume the AMIT has two classes of units – A and B, where the only difference between the classes is the performance fee charged. The AMIT derives franked dividends, interest and other income. Each class incurs a performance fee. The amounts of each income character and the performance fees are set out in the following table.*

Allocation of performance fees to Unit Classes (on a pro-rata basis)

	Total	**A**	**B**	**Class A**		
				Div	Int	Other
Units	500	100	400			
Dividend franked	7,000	1,400	5,600	1,400	4,000	1,000
Franking credits	3,000	600	2,400	600		
Interest	20,000	4,000	16,000			
Other	5,000	1,000	4,000			
Total income	35,000	7,000	28,000	2,000	4,000	1,000
Performance fee	-5,000	-1,000	- 4,000	- 219	- 625	- 156
Net income	30,000	6,000	24,000	1,781	3,375	844

32. *The performance fees relevant to a class are allocated to that class, and apportioned between the income characters (such as dividend and interest) of the class on a pro-rata basis. The AMIT disregards the franking credits for this purpose, which means that it does not apply any part of the fees against the franking credits.*

33. *Using the Class A performance fee of $1,000 and its allocation to dividends as an example, the table shows that $219 of this $1,000 fee is allocated to the Class A cash dividend of $1,400 as follows:*

- *Calculate the proportion of Class A cash dividends to Class A total income (excluding franking credits) thus:*

$$\frac{1{,}400}{1{,}400 + 4{,}000 + 1{,}000} = 21.87\%$$

- *Apply this proportion to the Class A performance fee of $1,000, that is, 21.87% of $1,000 = $219 (rounded to the nearest dollar).*

34. *As a result, net dividend income of $1,181 is attributable to Class A unitholders and a franking credit of $600 is attributable to Class A unitholders. The same method is applied to the other income characters (excluding franking credits) of Class A (as shown in the table in paragraph 31 of this draft Guideline) and to each income character of Class B (excluding franking credits) (not shown).*

35. *This method of expense allocation is a reasonable allocation of the performance fees for the purpose of section 276-270.*

Your comments

36. You are invited to comment on this Draft Law Companion Guideline including the proposed date of effect. Please forward your comments to the contact officer by the due date.

Due date:	**Friday, 15th January 2016**
Contact officer:	**David White**
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References

ATOlaw topic(s)	Income tax ~~ Trusts ~~ Other
Legislative references	ITAA 1997 ITAA 1997 8-1 ITAA 1997 Subdiv 115-C ITAA 1997 Subdiv 207-B ITAA 1997 Subdiv 276-E ITAA 1997 276-270 ITAA 1997 276-270(3) ITAA 1936 ITAA 1936 51AAA
Case references	*Ronpibon Tin NL v. FC of T (1949) 78 CLR 47*
Other references	Explanatory Memorandum to *Tax Laws Amendment (New Tax System for Managed Investment Trusts) Bill 2015,* par 3.35
ATO references	