TD 2011/21EC - Compendium

Ruling Compendium – for Rulings and Determinations

A compendium of responses to the issues raised by external parties to TD 2011/D1 Income tax: does it follow merely from the fact that an investment has been made by a trustee, including the trustee of a managed investment fund, that any gain or loss from the investment will be on capital account?

Summary of issues raised and responses

Issue No.	Issue raised	ATO Response/Action taken
1	**Title** The Draft TD would be better served if it was (simply) described as: Income tax: when will a gain or loss made by the trustee of a trust be on capital or revenue account?	The question was framed in this way so as to rebut the common assertion that trust gains are always on capital account. No change proposed.
2	**Scope** There should be 2 different determinations dealing with the 2 issues: • can a trustee only make a gain or loss on capital account? • what features may be relevant in deciding whether or not a trustee makes a gain or loss on revenue account?	We consider that the information is more accessible to users in one document. That is, the first determination suggested would of itself be of little utility to readers who would have to go in search of the related information. The two questions are intrinsically linked.
3	**Capital account presumption** As the preservation of the real value of the capital/corpus of a trust is a key factor for most (if not all) trustees, we think that at the very least a presumption should arise that the actions of a trustee which give rise to income are caused by the trustee discharging their fiduciary obligations to maintain the capital/corpus - i.e. that prima facie any gain made by a trustee will be on capital account.	Noted but not accepted. The case law establishes that each case will require an assessment of all relevant facts and circumstances to determine whether a gain or loss is on revenue or capital account.

4	**Footnote 2** Although footnote 2 suggests that the TD is not dealing with trading stock, examples 1 and 3 could well be circumstances where the investments are trading stock. That is, acquired and held for the purpose of sale in the ordinary course of business.	Noted but no change proposed. As identified in the issue raised, footnote 2 makes it clear that the TD is not dealing with trading stock and it is considered the examples are helpful even with this proviso.
5	**Example 1** Many of the factors are either equivocal or indeed support the proposition that the investments are on capital account. If an investment is in a security which "displays above-average earnings growth potential", the probability is that that investment will generate increased dividends in due course. This is consistent with a long term investment. Another factor is that the trustee will downgrade its view of the growth prospects of some securities as a consequence of changes in financial markets, the wider economy or earnings forecasts. This is consistent with a trustee seeking to preserve capital, not necessarily a trustee seeking to invest for profit. A further factor is that on average the turnover (which, in the writer's opinion, is a concept which needs to be defined), whilst varying from year to year, exceeds 10%. One needs to consider why the variations have occurred and not simply focus upon a generic turnover percentage. Trust deeds typically provide the trustee with broad powers to vary investments and to distribute any part of the trust fund at any time: it would be rare to find a trust deed that does not provide for the trustee to have these powers. Recognition of gains on securities at fair value is generally consistent with the adoption of appropriate accounting standards. Indeed, some unit trusts, particularly where they are managed investments, are required to do so.	Noted. The Determination makes the point however that all relevant factors need to be considered and weighed together, which the Determination now notes on balance supports a revenue characterisation. It has also been clarified that the trust was established to ensure a substantial annual return for unitholders in respect of share investments. Given this purpose and the structure of the investments, a return of profits on share sales would seem to have always been in contemplation.

6.	**Example 2** With respect to the ATO, there is nothing "on balance" about the situation in Example 2 - the gains and losses made by the trust are clearly on capital account. In referring to the annual portfolio turnover of the trust being about 10% the ATO seems to be attributing a general significance to the decision in the London Australia case which we believe is not warranted.	Comment noted but not accepted. In the years in question the beneficiary had substantial medical expenses. The trustee may have sought to meet those expenses by buying and selling shares at a profit, in a similar way to how, for example, the income needs of the income beneficiary in *Orr v. Wendt & Ors* [2005] WASCA 199 were met out of a strategy of buying and selling shares at a profit. All of the relevant circumstances need to be considered when characterising any gain or loss.
7.	**Example 4** We are concerned by paragraph 28 - for the ATO to suggest that there is any question about the gains or losses in this situation being anything other than on capital account is a worrying development for the middle market. In our view: • the nature of the trust (i.e. to assist the family and to provide for the retirement of the husband and wife); and • the trustee's duties to, at the very least, preserve the real value of the capital/corpus of the trust, both clearly point towards a capital account characterisation. There are many trusts in the middle market that would operate in the same/a similar manner to the trust in this case. In our view ATO staff need to be informed in unequivocal language that they should accept that the gains and losses produced by these trusts are on capital account.	Comments noted but not accepted. Each case will involve an assessment of all relevant facts and circumstances. One purpose in establishing the trust in this example was to provide for the needs of the family. This might be best achieved through the buying and selling of investments at a profit. The nature and extent of the trustee's trading activities would need to be considered when characterising any gain or loss.

8.	**Paragraph 51** This paragraph should be removed from the Draft TD - just about every modern trust deed (and a fair number of older ones as well) will authorise a trustee to engage in a business. That is, to say that the mere fact that a trustee is authorised to do something supports a conclusion that the profits or losses made by the trust are on revenue account is akin to arguing that any gain/loss made by an individual will be on revenue account because an individual is allowed to be a share trader - the issue must always be whether the individual/trustee is actually trading on revenue account.	Comments noted. Paragraph amended to focus on a situation where having regard to the purposes of the trust it is clear that the trust exists with a view to generating profits from which distributions to investors can be made.
9.	In our view it would be useful if the ATO could better articulate what it means by saying that 'where share trades are made in the context of a large commercially managed share portfolio, a particular rate of turnover may have a different significance than it would have in a small family context.' For example, does this statement mean that the ATO will (prima facie) regard the gains/losses made by any commercially managed share portfolio that has a value of (say) in excess of $10 million as being on revenue account? In other words, what is a "small family context" - is this measured by the number of family members, the $ value of the investment portfolio or a combination of the above - and what exactly is 'a large commercially managed share portfolio'? There are a number of families in the middle market whose wealth is such that their investment portfolios either demand or justify being commercially managed. ATO staff should be encouraged not to automatically assume that just because a trust fund is commercially managed it is producing gains/losses on revenue account	The focus of the statement was the size of the portfolio. The Determination has been amended to reflect this.

10.	**Paragraphs 57 and 58** The parts of TR 2005/23 that the ATO believes are relevant to the consideration of the subject matter of this Draft TD should actually be reproduced in the Draft TD – readers should not be forced to speculate as to what are the ‘related issues’ mentioned in paragraph 57 and nor should they have to 'second guess' as to whether a trust is established with ‘similar objectives’ to a listed investment company as per paragraph 58.	Agree. Determination amended in this regard.