PS LA 2004/3 (Withdrawn) - Taxation of capital gains of a trust that has separate income and capital beneficiaries

Please Note: This practice statement was withdrawn on 1 September 2005. It has been replaced by PS LA 2005/1 (GA) - Taxation of capital gains of a trust.

This document has changed over time. This version was published on *1 September 2005*

ATO Practice Statement
Law Administration

PS LA 2004/3

Please Note: This practice statement was withdrawn on 1 September 2005. It has been replaced by PS LA 2005/1 (GA) - Taxation of capital gains of a trust.

FOI status: may be released

This Practice Statement is issued under the authority of the Commissioner and must be read in conjunction with Law Administration Practice Statement PS LA 1998/1. It must be followed by ATO officers unless doing so creates unintended consequences. Where this occurs ATO officers must follow their Business Line's escalation process.

SUBJECT: **Taxation of capital gains of a trust that has separate income and capital beneficiaries**

PURPOSE: **To outline approaches the Commissioner will accept for the taxation of capital gains included in the net income of a trust**

STATEMENT

1. This statement sets out approaches the Commissioner will accept for the taxation of a net capital gain included, for an income year, in the net income of a resident trust estate having:

- trust income for the relevant income year to which a beneficiary is presently entitled, and
- different (or potentially different[1]) income and capital beneficiaries.

2. This statement does not deal with cases where a trust deed has a clause purporting to equate trust income with net income for the purposes of section 95 of the *Income Tax Assessment Act 1936* (ITAA 1936).

Approaches that the Commissioner will accept

Proportionate approach

3. In accordance with the 'proportionate approach' to the taxation of the net income of a trust, an income beneficiary who is presently entitled to trust income would be treated as having an extra capital gain or gains in proportion to their interest in the trust income. For example, an amount assessed to a beneficiary under paragraph 97(1)(a) of the ITAA 1936 that is attributable to a capital gain of the trust, is treated

[1] Beneficiaries may potentially be different because their character as a capital or income beneficiary depends on the exercise of a trustee's discretion.

as an extra capital gain of the beneficiary, 'grossed up' where appropriate (see section 115-215 of the *Income Tax Assessment Act 1997* (ITAA 1997)).

4. However, treating an income beneficiary as having an extra capital gain or gains may not be appropriate if the gain relates to an amount that benefits a capital beneficiary.

Capital beneficiary approach

5. Accordingly, the Commissioner accepts treating a capital beneficiary as having the extra capital gain or gains for the purposes of Subdivision 115-C of the ITAA 1997 to the extent that the beneficiary either has:

- by the end of the year of income, a vested and indefeasible interest in the trust capital representing the trust's capital gain or, where the trust's capital gain is a 'deemed' amount (because for example, the market value substitution rule in section 116-30 of the ITAA 1997 applied to determine the capital proceeds), would have had such an interest if the gain were represented by actual trust capital), or
- received the trust capital gain by way of advancement or appointment under the terms of the trust deed during or within two months of the end of the income year. In determining whether the trust capital gain has been advanced or appointed the Commissioner will rely on the way the trustee characterises it.

Trustee approach

6. The Commissioner will also accept, as an alternative to the capital beneficiary approach set out in paragraph 5, an assessment of the capital gain, or a portion of it, to the trustee. However, the Commissioner will only accept this approach if no tax is avoided as compared with at least one of the proportionate approach or the capital beneficiary approach.

Requirement for agreement

7. The capital beneficiary and trustee approaches can be used only if the income beneficiaries, capital beneficiaries (referred to in paragraph 5) and the trustee agree in writing to use it. If a beneficiary is a subsidiary member of a consolidated group, then the head company of the group must be a party to the agreement. If there are a number of capital beneficiaries and some do not agree to make extra capital gains, they must still all agree for the trustee to be assessed on any part of it.

8. An agreement and any trustee resolution to give effect to it must be made within two months of the close of the relevant income year. The agreement does not need to be provided to the Tax Office but should be available if requested. An agreement for an income year should be kept for 5 years after the end of that year.

9. A capital beneficiary can only agree to have extra capital gains to the extent that they have a vested and indefeasible interest in the trust capital representing the capital gain at the end of the year of income. For example, a beneficiary who has a vested and indefeasible interest in 50% of the trust capital cannot agree to have extra capital gains in relation to 100% of the trust capital nor can the beneficiary agree to have capital gains in relation to 25% of the trust capital.

10. If one of the parties to the agreement does not prepare their income tax return in accordance with the agreement (or challenges an assessment made in accordance

with it), the Commissioner will ignore the agreement in assessing the other parties. In that situation, the income beneficiary or trustee will be assessed depending on the existence of present entitlement to trust income for the year.

11. The appendix contains a flowchart that summarises the application of this Practice Statement.

EXPLANATION

12. Subdivision 115-C of the ITAA 1997 provides that a beneficiary of a trust (whose net income includes capital gains) is treated as having made certain extra capital gains if the beneficiary's assessable income includes an amount under paragraph 97(1)(a), subsection 98A(1), or subsection 100(1) of the ITAA 1936. Subsection 115-215(6) of the ITAA 1997 provides for a deduction so that an amount is not assessed under one of those provisions as well as being treated as an extra capital gain.

13. Under section 97 of the ITAA 1936, an Australian resident beneficiary, who is not under a legal disability and who is presently entitled to a *share* of trust income, must include in their assessable income their share of the net income of the trust estate worked out under subsection 95(1) of the ITAA 1936. Sections 98A and 100 of the ITAA 1936 operate similarly in respect of other beneficiaries.

14. The courts have determined that the 'share' of net income that must be included in assessable income is based on the proportion of the trust income to which the beneficiary is presently entitled: *Zeta Force Pty Ltd v. Federal Commissioner of Taxation* 98 ATC 4681 at 4693; (1998) 39 ATR 277. See also *Davis v. FC of T* 89 ATC 4377; 20 ATR 548; (1989) 86 ALR 195; *DCT v. Richard Walter Pty Ltd* (1995) 29 ATR 644; (1995) 183 ALR 168; (1995) 69 ALJR 223; 95 ATC 4067 and *FCT v. Prestige Motors Pty Ltd* (1994) 27 ATR 160; (1993) 118 ALR 497; (1993) 47 FCR 138; 93 ATC 5021 (contrast Merkel J in *Richardson v. FC of T 97* ATC 5098; (1997) 150 ALR 167; 37 ATR 452; (1997) 80 FCR 58).

15. None of these cases expressly deals with the situation where there are different income and capital beneficiaries, and so it is open to the Commissioner to take an approach which promotes the purpose of the relevant provisions.

16. If the net income of a trust includes a net capital gain and there are separate income and capital beneficiaries, the application of the proportionate approach produces an inequitable outcome – the income beneficiary is taken to have made extra capital gains and may be assessed on an amount from which they will not benefit.

17. The Tax Office has administered the law in a way that provides a workable solution whether before or after the enactment of Subdivision 115-C of the ITAA 1997. At the meeting of the Capital Gains Tax Subcommittee of the Tax Liaison Group on 22 September 1988, Second Commissioner Brian Nolan stated that 'it is the ATO practice to assess any [excess of] net income over trust accounting income because of a capital gain to the capital beneficiary'. The ATO practice is also reflected in paragraph 4 of Taxation Determination TD 93/35.

18. The Commissioner will, in the interests of practical administration, continue to apply the previous practice as modified in this Practice Statement.

Examples

Example 1

19. *The Glass Fixed Trust has two beneficiaries. Charles is the capital beneficiary, and Joanne is the income beneficiary. The trust makes a capital gain of $10,000 (which, it is assumed, could not be reduced by the CGT discount) during the 2002–03 income year. The trust has no current year capital losses or prior year net capital losses, and the trust made no other capital gains during the income year. The trust also derived rental income of $5,000 during the income year.*

20. *The net income of the trust estate for the 2002–03 income year is $15,000 ($10,000 plus $5,000). The trust income for the same income year is $5,000. Joanne is presently entitled to all of the income of the trust estate.*

21. *Unless Joanne, Charles and the trustee agree otherwise, Joanne will include the $5,000 directly in her assessable income and $10,000 in the calculation of her net capital gain.*

22. *The parties can agree however that Charles include the $10,000 capital gain in the calculation of his net capital gain and that Joanne include the remaining $5,000 net income of the trust in her assessable income.*

23. *Alternatively the parties can agree that the trustee be assessed on the $10,000 provided that the tax is at least the lesser of what Joanne or Charles would have been liable for. Joanne will be assessed on the remaining $5,000 of net income.*

24. *Note that if the trust's capital gain had been eligible for the CGT discount, then the trust's net capital gain would have been $5,000. Joanne or Charles would have been required to 'gross up' (ie double) the capital gain and apply their capital losses before applying the CGT discount. However, the benefit of the CGT discount would be reversed if the trustee were assessed under section 99A of the ITAA 1936 (that is, the trustee would be assessed on $10,000).*

Example 2

25. *Assume the facts in example 1, but change them so that there are only discretionary capital beneficiaries for the Glass Trust and that none of the capital gain has been advanced during the 2002-03 income year.*

26. *If Joanne and the trustee do not agree otherwise, Joanne will include the $5,000 directly in her assessable income and $10,000 in the calculation of her net capital gain. Alternatively, they can agree that the trustee be assessed on the $10,000 capital gain. Joanne will be assessed on the remaining $5,000 of net income.*

27. *As there is no beneficiary with a vested and indefeasible interest in the proceeds of the gain, there is no possibility of a capital beneficiary making an extra capital gain. Further it is not necessary to obtain the agreement of any potential capital beneficiary to a trustee assessment.*

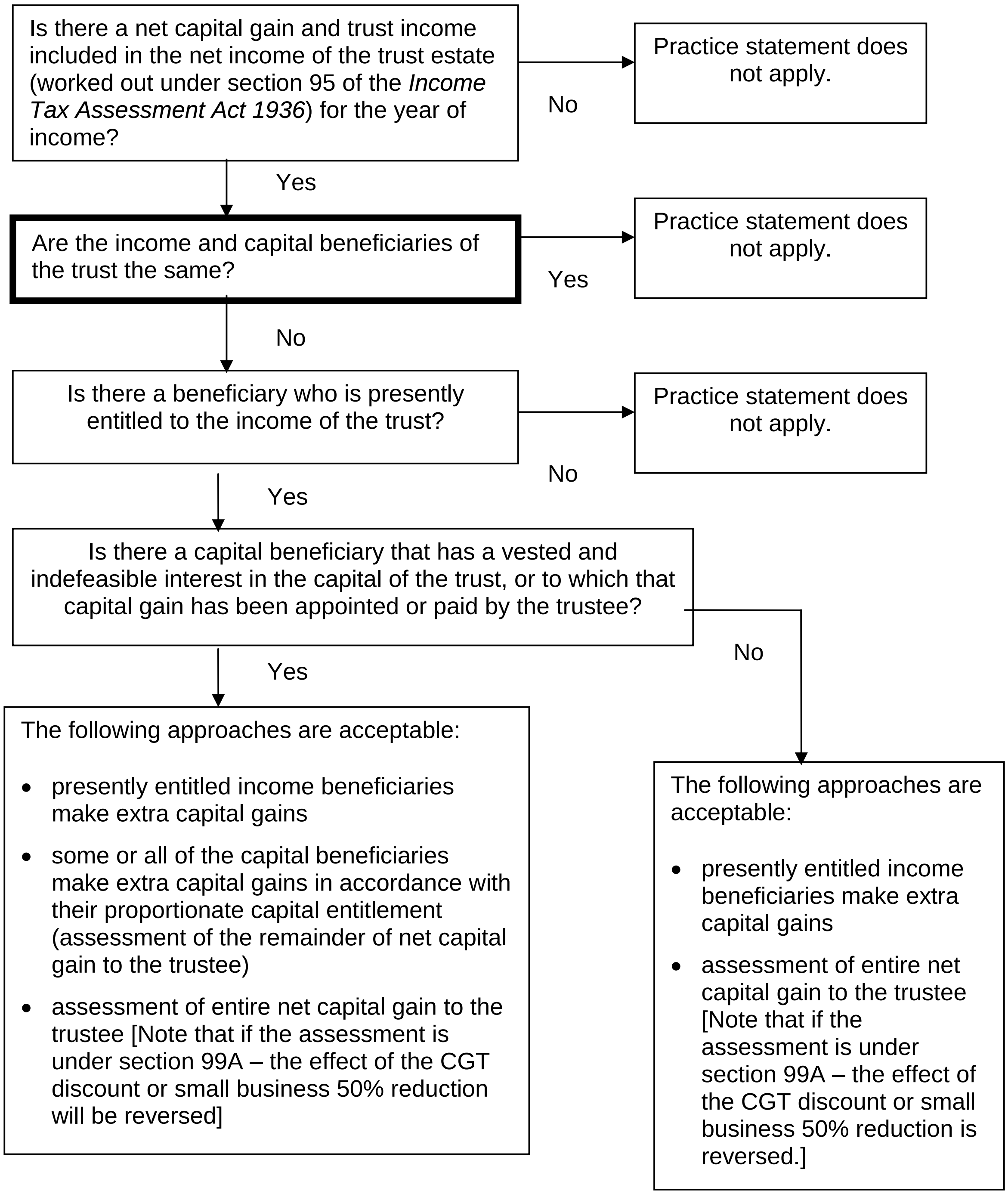
Example 3

28. *Assume the facts in example 1, but change them so that there are two capital beneficiaries, Charles and Jim. Each has a vested and indefeasible interest in 50% of the trust capital representing the net capital gain.*

29. The acceptable methods of taxing the net capital gain are:

- *Joanne is taken to have made an extra capital gain of $10,000 which she takes into account in working out her net capital gain*
- *with the agreement of Joanne, Charles, Jim and the trustee – Charles and Jim are taken to have made an extra capital gain of $5,000 each, which they take into account in working out their net capital gain*
- *with the agreement of Joanne, Charles, Jim and the trustee – the trustee is assessed on $5,000 of the net capital gain and either Charles or Jim (but not both) is taken to have made an extra capital gain of $5,000 which he takes into account in working out his net capital gain, or*
- *with the agreement of Joanne, Charles, Jim and the trustee – the trustee is assessed on the $10,000 net capital gain.*

Appendix: Flowchart summarising application of the Practice Statement for the assessment of a net capital gain.



subject references:	capital gains; life interests; net income of a trust; present entitlement; remainder beneficiaries; trust income
legislative references:	*Income Tax Assessment Act 1936* section 95 *Income Tax Assessment Act 1936* subsection 95(1) *Income Tax Assessment Act 1936* section 97 *Income Tax Assessment Act 1936* paragraph 97(1)(a) *Income Tax Assessment Act 1936* section 98A *Income Tax Assessment Act 1936* subsection 98A(1) *Income Tax Assessment Act 1936* section 99 *Income Tax Assessment Act 1936* section 99A *Income Tax Assessment Act 1936* section 100 *Income Tax Assessment Act 1936* subsection 100(1) *Income Tax Assessment Act 1997* Subdivision 115-C *Income Tax Assessment Act 1997* subsection 115-215(6) *Income Tax Assessment Act 1997* section 116-30
related public rulings:	Taxation Determination TD 93/35
related practice statements:	Law Administration Practice Statement PS LA 2002/11
case references:	*Davis v. FC of T* 89 ATC 4377; 20 ATR 548; (1989) 86 ALR 195 *DCT v. Richard Walter Pty Ltd* (1995) 29 ATR 644; (1995) 183 ALR 168; (1995) 69 ALJR 223; 95 ATC 4067 *FCT v. Prestige Motors Pty Ltd* (1994) 27 ATR 160; (1993) 118 ALR 497; (1993) 47 FCR 138; 93 ATC 5021; 27 ATR 160 *Richardson v. FC of T* 97 ATC 5098; (1997) 150 ALR 167; 37 ATR 452; (1997) 80 FCR 58 *Zeta Force Pty Ltd v. Federal Commissioner of Taxation* 98 ATC 4681; (1998) 39 ATR 277
file references:	2004/963

Date issued:	**22 January 2004**
Date of effect:	**Ongoing**