CR 2007/118 - Income tax: capital gains: amendment of trust constitution: ConnectEast Investment Trust

Class Ruling

Income tax: capital gains: amendment of trust constitution: ConnectEast Investment Trust

Contents Para

This publication provides you with the following level of protection:

This publication (excluding appendixes) is a public ruling for the purposes of the *Taxation Administration Act 1953*.

A public ruling is an expression of the Commissioner's opinion about the way in which a relevant provision applies, or would apply, to entities generally or to a class of entities in relation to a particular scheme or a class of schemes.

If you rely on this ruling, we must apply the law to you in the way set out in the ruling (unless we are satisfied that the ruling is incorrect and disadvantages you, in which case we may apply the law in a way that is more favourable for you – provided we are not prevented from doing so by a time limit imposed by the law). You will be protected from having to pay any underpaid tax, penalty or interest in respect of the matters covered by this ruling if it turns out that it does not correctly state how the relevant provision applies to you.

What this Ruling is about

1. This Ruling sets out the Commissioner's opinion on the way in which the relevant provision(s) identified below apply to the defined class of entities, who take part in the scheme to which this Ruling relates.

Relevant provision(s)

2. The relevant provisions dealt with in this Ruling are:

- subsection 6(1) of the *Income Tax Assessment Act 1936* (ITAA 1936);
- section 104-10 of the *Income Tax Assessment Act 1997* (ITAA 1997) (capital gains tax (CGT) event A1 – disposal of a CGT asset);
- section 104-25 of the ITAA 1997 (CGT event C2 – cancellation, surrender and similar endings);
- section 104-70 of the ITAA 1997 (CGT event E4 – capital payment for trust interest);
- section 104-75 of the ITAA 1997 (CGT event E5 – beneficiary becoming entitled to a trust asset);

- section 104-80 of the ITAA 1997 (CGT event E6 – disposal to beneficiary to end income right);
- section 104-85 of the ITAA 1997 (CGT event E7 – disposal to beneficiary to end capital interest);
- section 104-90 of the ITAA 1997 (CGT event E8 – disposal by beneficiary of capital interest);
- section 104-155 of the ITAA 1997 (CGT event H2 – receipt for event relating to a CGT asset); and
- Division 855 of the ITAA 1997.

Class of entities

3. The class of entities to which this Ruling applies is the unitholders of the ConnectEast Investment Trust (the Trust) who are either residents of Australia as that term is defined in subsection 6(1) of the ITAA 1936 or foreign residents, where the units held are taxable Australian property for the purposes of Division 855 of the ITAA 1997.

Qualifications

4. The Commissioner makes this Ruling based on the precise scheme identified in this Ruling.

5. The class of entities defined in this Ruling may rely on its contents provided the scheme actually carried out is carried out in accordance with the scheme described in paragraphs 13 to 34 of this Ruling.

6. If the scheme actually carried out is materially different from the scheme that is described in this Ruling, then:

- this Ruling has no binding effect on the Commissioner because the scheme entered into is not the scheme on which the Commissioner has ruled; and
- this Ruling may be withdrawn or modified.

Date of effect

8. This Ruling applies from 1 July 2007 to 30 June 2008. However, the Ruling continues to apply after 30 June 2008 to all entities within the specified class who entered into the specified scheme during the term of the Ruling.

9. The Ruling does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling. Furthermore, the Ruling only applies to the extent that:

- it is not later withdrawn by notice in the *Gazette*; or
- the relevant provisions are not amended.

10. If this Ruling is inconsistent with a later public or private ruling, the relevant class of entities may rely on either ruling which applies to them (item 1 of subsection 357-75(1) of Schedule 1 to the *Taxation Administration Act 1953* (TAA)).

11. If this Ruling is inconsistent with an earlier private ruling, the private ruling is taken not to have been made if, when the Ruling is made, the following two conditions are met:

- the income year or other period to which the rulings relate has not begun; and
- the scheme to which the rulings relate has not begun to be carried out.

12. If the above two conditions do not apply, the relevant class of entities may rely on either ruling which applies to them (item 3 of subsection 357-75(1) of Schedule 1 to the TAA).

Scheme

13. The following description of the scheme is based on information provided by the applicant. The following documents or relevant parts of them form part of and are to be read with the description:

- Application for a Class Ruling dated 10 September 2007, made by KPMG Tax Lawyers Pty Limited on behalf of the Responsible Entity of the Trust;
- email correspondence from KPMG Tax Lawyers Pty Limited on behalf of the Responsible Entity of the Trust dated 1 November 2007 and 16 November 2007; and
- Constitution of the Trust incorporating the proposed amendments in ‘marked-up’ form.

Note: certain information has been provided on a commercial-in-confidence basis and will not be disclosed or released under the Freedom of Information legislation.

Background

14. ConnectEast Management Limited is the Responsible Entity of the Trust in terms of the *Corporations Act 2001* (the Corporations Act).

15. The Constitution governing the Trust was adopted on 25 April 2004.

16. Pursuant to clause 3.1 of the Constitution the beneficial interest in the Trust is divided into units.

17. The units in the Trust, as provided under clause 27 of the Constitution, are stapled units. Each unit in the Trust is stapled to a unit in the ConnectEast Holding Trust (Holding Trust). As a consequence of these units being stapled together, while the stapled security may be transferred or otherwise dealt with, individual units in the Trust and Holding Trust may not.

18. In response to the adoption of the International Financial Reporting Standards (AIFRS) and, in particular, Australian Accounting Standard 132 (AASB 132), the Responsible Entity proposes to alter the Constitution of the Trust but in a manner that does not cause the creation of a new trust.

19. Based on the current terms of the Trust's Constitution, which also confers an express power to alter the termination date, the Trust must be wound up after 75 years provided no earlier termination event arises.

20. After 75 years, invested funds in the Trust would need to be returned to unitholders. Accordingly, the Trust has been disclosing unitholders' funds in the balance sheet as debt (rather than equity) pursuant to AASB 132.

21. As the recognition of unitholders' funds as debt rather than equity for financial reporting purposes creates a number of significant practical issues, the Responsible Entity proposes to remove the Trust's fixed termination date and amend the definition of liabilities to exclude both unit capital and amounts payable to unitholders on that capital.

Termination date of the Trust

22. Pursuant to clause 20.2 of the Trust's Constitution, the Trust will be regarded as having vested on the completion of the winding up and distribution of all the assets.

23. Winding up of the Trust is made with reference to the 'Winding-up Commencement Date' in clause 20.3. The 'Winding-up Commencement Date' is defined as the first to occur of the following dates:

- the seventy-fifth anniversary of the date the Trust commenced;
- the date of delisting;
- a date which Members determine by a Special Resolution;
- the date upon which it is decided to wind up the Trust under article 20.3;
- the date upon which the Trust is to be wound up under statute or general law; and
- the date upon which it is decided to wind-up the Stapled Trusts if at that time the Units are stapled to the Stapled Units.

Proposed amendments to the termination date

24. The proposed amendment to the Trust's Constitution in relation to the termination date of the Trust is as follows:

- removal of the seventy-fifth anniversary of the date the Trust commenced from the definition of the 'Winding up Commencement Date' for the purposes of clause 20.3 (which becomes Clause 20.4); and
- insertion of Clause 20.3 which reads:

  > The perpetuity period for the purposes of section 5 of the *Perpetuities and Accumulations Act 1968 (Vic)* is the period of 75 years from the day prior to the commencement of the Trust. Despite any other provisions in this constitution, no Units may be issued or redeemed (if permitted under this constitution), after the 75th anniversary of the day preceding the day the Trust commenced, unless that issue or redemption would not offend the rule against perpetuities, or any other rule of law or equity. The specification of a perpetuity period in this article 20.3 does not require the Trust terminate on the expiration of that period.

Liabilities

25. Pursuant to AASB 132, a financial instrument should be classified as either a financial liability or an equity instrument according to the substance of the contract and not its legal form.

26. In accordance with AASB 132, a financial instrument is classified as an equity instrument only if:

- the instrument includes no contractual obligation for the issuer to deliver cash or another financial asset to another entity; and
- if the instrument will or may be settled in the issuer's own equity instruments, it is either:
  - (a) a non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments; or
  - (b) a derivative that will be settled only by the issuer exchanging a fixed amount of cash or other financial asset for a fixed number of its own equity instruments.

27. The recognition of unitholders' funds as debt rather than equity for financial reporting purposes creates a number of significant practical issues, including:

- the change in disclosure creates significant confusion in the minds of the investing public when seeking to understand the financial accounts;
- the distribution clause provides the trustee with discretion as to distribution of income; and
- if unitholders' funds are treated as debt for accounting purposes then distributions to unitholders would constitute an interest expense in the Income Statement and hence, change the net income of the Trust.

28. Under AIFRS, units in the Trust will be classified as debt instruments if the responsible entity has a 'contractual obligation' to pay an ascertainable amount to unitholders.

29. The current definition of 'liabilities' in the Trust's Constitution does not explicitly exclude unit capital or amounts payable to unitholders on that capital from the definition.

30. For the purposes of clarity, the Responsible Entity proposes amendments to specifically exclude unit capital or amounts payable to unitholders on that capital.

31. The current definition of 'liabilities' in the interpretations section in Clause 32 of the Trust's Constitution is as follows:

> All present liabilities of the Trust including any provision which the Manager decides should be taken into account in determining the liabilities of the Trust, but not liabilities:
>
> (a) Attached to application money or property in respect of which Units have not yet been issued; or
>
> (b) Arising by virtue of the right of Members to have their units redeemed.

Proposed amendment

32. The proposed amendment to the definition of 'liabilities' is as follows:

> All present liabilities of the Trust including any provision which the Manager decides should be taken into account in determining the liabilities of the Trust but not liabilities:
>
> (a) To applicants for Units in respect of application money or property in respect of which Units have not yet been issued; or
>
> (b) To Holders, arising by virtue of the right of Holders to request redemption of their Units or to participate in the distribution of the Assets on the winding up of the Trust.

33. The Trust's accountants have indicated that these amendments will satisfy AASB 132.

34. The Responsible Entity proposes to make these amendments to the Constitution by 31 December 2007.

Ruling

35. The proposed amendments to the Trust's constitution will not of itself result in the happening of any of the following CGT events:

- section 104-10 of the ITAA 1997 (CGT event A1 – disposal of a CGT asset);
- section 104-25 of the ITAA 1997 (CGT event C2 – cancellation, surrender and similar endings);
- section 104-70 of the ITAA 1997 (CGT event E4 – capital payment for trust interest);
- section 104-75 of the ITAA 1997 (CGT event E5 – beneficiary becoming entitled to a trust asset);
- section 104-80 of the ITAA 1997 (CGT event E6 – disposal to beneficiary to end income right);
- section 104-85 of the ITAA 1997 (CGT event E7 – disposal to beneficiary to end capital interest);
- section 104-90 of the ITAA 1997 (CGT event E8 – disposal by beneficiary of capital interest); and
- section 104-155 of the ITAA 1997 (CGT event H2 – receipt for event relating to a CGT asset).

Commissioner of Taxation
19 December 2007

Appendix 1 – Explanation

This Appendix is provided as information to help you understand how the Commissioner's view has been reached. It does not form part of the binding public ruling.

36. This Ruling sets out the income tax consequences of the amendments, as described in the application, to the Trust's Constitution current at the date of application. The amendments to the Constitution are subject to the Corporations Act, in particular Chapter 5C of that Act. This Ruling should not be taken as implying any view as to whether the Corporations Act has been complied with. This Ruling should not be taken as implying any view as to whether the units in the Trust have been classified as equity instruments under AASB 132.

37. Any amendment to the constitution of a trust may alter the nature and character of the trust relationship to such an extent that for the purposes of trust law the previous trust has come to an end and a new trust has been created. In such circumstances a resettlement is said to have taken place in respect of all or only part of the assets of the original trust. The effect at common law of such a resettlement is that there has been a disposal of the trust assets, and as such is likely to have capital gains tax consequences. Specifically, a capital gain could accrue to a beneficiary as a result of the occurrence of various capital gains tax events. This capital gain would form part of the beneficiary's assessable income for tax purposes unless the beneficiary had other capital losses against which the gain could be netted off (section 102-5 of the ITAA 1997).

38. The Commissioner issued a paper titled 'Trust resettlements – AIFRS related amendments to trust deeds' on 10 September 2007 (the September 2007 paper). The paper supplements, but does not supplant, the existing Tax Office publication, 'Creation of a new trust – Statement of Principles August 2001' issued on 29 August 2001. These two publications do not cover all possibilities or circumstances of every taxpayer. The answer to the question of whether alterations to trusts, taken together, result in terminations and creations of trust estates will flow from establishing whether the essential character and nature of the original trust relationship has fundamentally changed.

39. The September 2007 paper applies to all trusts that are Australian reporting entities and prepare financial statements in accordance with AIFRS. It provides guidance on whether certain amendments made to the constitution of such a trust in response to AIFRS causes the trust to end. Relevantly, for present purposes, these amendments include amendments designed to:

- remove the trust's fixed termination date and add a clause to the effect that no units may be issued or redeemed after the original termination date; and
- clarify that members' funds are not classified as liabilities of the trust.

40. A consequence of an existing trust ending, and a new trust being created, by virtue of an amendment to a trust constitution is that, amongst other things, one or more CGT events may happen.

41. In the present case, two of the steps in the scheme are the removal of the existing fixed termination date and the inclusion of a new clause in the Trust's Constitution (20.3) to prohibit the issue or redemption of any units on or after the original end date.

42. The stated purpose in undertaking these two steps is to ensure, following the introduction of AIFRS, that members' funds continue to be treated as equity, rather than liabilities, for accounting purposes.

43. The removal of the fixed termination date means that the Trust will not automatically end on that date and could continue beyond that date.

44. New clause (20.3) is judged to be necessary as, as things stand, an issue or redemption of units may cause a contravention of the rule against perpetuities, or some other rule of law or equity.

45. In the particular circumstances of the case, it is apparent that the extension of the term of the Trust is consistent with a continuing trust estate.

46. The Commissioner notes that the Responsible Entity can only amend the Trust Constitution in accordance with ASIC Class Order CO 05/566 if it reasonably considers that the termination date was included in the Constitution to avoid the Trust breaching the rule against perpetuities, and that its removal would not change materially the nature of the trust relationship nor have a materially adverse effect on members' interests.

47. It is apparent that the removal of the fixed termination date, which had been included to avoid any contention that the rule against perpetuities had been infringed, does not constitute a fundamental change to the trust relationship. This approach conforms to the views expressed in the September 2007 paper.

48. The current definition of 'liabilities' at clause 32 does not expressly exclude unit capital or amounts payable to unitholders on that capital from the definition of liabilities.

49. The proposed amendments to the definition of 'liabilities' have the sole purpose of excluding unit capital or amounts payable to unitholders on that capital. Accordingly, they clarify that members' funds will not be classified as liabilities of the Trust. This approach conforms to the views expressed in the September 2007 paper.

50. Accordingly, in the present case, the Commissioner considers that the proposed amendments to the Trust's Constitution as described in the application do not trigger any of the CGT events listed in paragraph 2 of this Ruling.

Appendix 2 – Detailed contents list

51. The following is a detailed contents list for this Ruling:

References

Previous draft:

Not previously issued as a draft

Subject references:

- capital gains tax
- CGT events
- trust resettlements
- trusts
- unit trusts
- unitholders

Legislative references:

- ITAA 1936 6(1)
- ITAA 1997 102-5
- ITAA 1997 104-10
- ITAA 1997 104-25
- ITAA 1997 104-70
- ITAA 1997 104-75
- ITAA 1997 104-80
- ITAA 1997 104-85
- ITAA 1997 104-90
- ITAA 1997 104-155
- ITAA 1997 Div 855
- ITAA 1997 855-10
- TAA 1953
- TAA 1953 Sch 1 357-75(1)
- Copyright Act 1968
- Corporations Act 2001
- Corporations Act 2001 Ch 5C
- Perpetuities and Accumulations Act 1968 (Vic) 5

Other references:

- Australian Accounting Standard 132
- Creation of a new trust – Statement of Principles August 2001
- Trust resettlements – AIFRS related amendments to trust deeds
- ASIC Class Order CO05/566

ATO references

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