TD 2011/21 - Income tax: does it follow merely from the fact that an investment has been made by a trustee that any gain or loss from the investment will be on capital account for tax purposes?

There is a Compendium for this document: **TD 2011/21EC** .

Taxation Determination

Income tax: does it follow merely from the fact that an investment has been made by a trustee that any gain or loss from the investment will be on capital account for tax purposes?

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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, the Commissioner must apply the law to you in the way set out in the ruling (unless the Commissioner is satisfied that the ruling is incorrect and disadvantages you, in which case the law may be applied to you in a way that is more favourable for you – provided the Commissioner is 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.

Ruling

1. No. The mere fact that a gain or loss from an investment is made by an entity in its capacity as trustee of a trust is not conclusive as to whether the gain or loss is on revenue or capital account for tax purposes.

2. The gain or loss is on revenue account for tax purposes if no provision of the income tax law specifically treats it as being on capital account[1] and, after a wide survey and exact scrutiny of all of the relevant factors, it is determined that the gain or loss was from:

- a normal operation in the course of carrying on a business of investment;[2]

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[1] Certain provisions that apply to trustees override the general position by providing that capital gains tax (CGT) is the primary code for calculating gains and losses (see for example section 275-100 of the *Income Tax Assessment Act 1997* (ITAA 1997) (which applies in respect of certain assets owned by the trustee of a managed investment trust); section 295-85 of the ITAA 1997 (which applies to certain complying superannuation entities) and subsection 394-30(7) of the ITAA 1997 (which applies in respect of certain investments in a forestry managed investment scheme)).

[2] This Determination does not apply in a case where the 'investment' is trading stock in a business carried on by the trustee (for example, the trustee carries on a business of share trading).

- an extraordinary operation by reference to the ordinary course of that business but one entered into with the intention of making a profit or gain; or
- a one-off or isolated transaction where the investment was acquired in a business operation or commercial transaction for the purpose of profit-making.[3]

3. The nature of the trust and the terms and content of the trustee's duties are important considerations in the characterisation process. However they are not necessarily determinative in any particular case. They must be carefully weighed together with other factors.

4. Other factors which would assist in determining whether the gain or loss is on revenue or capital account include

- the nature and scale of the trustee's investment and other activities;
- the investment style employed in respect of the trust assets;
- the nature of the trust assets;
- the length of time individual investments are held, the regularity in sale activity involving the trust assets;
- the average annual turnover of the trust assets;
- the percentage of total income which the gains represent; and
- the nature of any connection between the trustee and other parties to the dealings.

Example 1: pooled investment trust

5. *ENTrust is a unit trust established to invest in listed securities and is marketed as providing an investment opportunity that is forecast to provide substantial quarterly returns for its unitholders in proportion to their respective unitholdings. The trust is not a managed investment trust for the purposes of Subdivision 275-A of the ITAA 1997.*

6. *The trustee's investment policy is to target securities which display above-average earnings growth potential. Periodically, due to changes in the financial markets, the wider economy or the earnings forecasts of individual securities, the trustee will downgrade its view of the growth prospects of some securities in its portfolio. This will normally lead to the sale of some or all of these securities.*

7. *While the level of sales varies significantly from year to year, on average the turnover of stock as a percentage of the market value of the portfolio exceeds 10%. It is forecast that, in aggregated terms, profits will be realised on such disposals.*

8. *The trustee recognises gains on securities at 'fair value' for accounting purposes. The trustee relies on these recognised gains to support in large part the regular distributions it makes to its unitholders.*

9. *The expectation of these and other profits (including dividend and interest income) underlies the indicative returns set out in the marketing material provided to prospective unitholders.*

[3] See paragraphs 15 and 16 of Taxation Ruling TR 92/3 Income tax: whether profits on isolated transactions are income, which summarise the overall position for isolated and non-isolated transaction cases.

10. *Under the trust's deed, the trustee has broad powers to vary investments. It also has an unfettered discretion to distribute any part of the trust fund at any time. The trustee is also obliged, when requested by unitholders and provided the fund remains liquid, to redeem units for a price based on the net asset value of the trust (which will include any unrealised gains booked by the trustee). The existence of this right to have units redeemed provides unitholders with an ability to exit the trust should distributions made by the trustee fail to yield an adequate return on their investment.*

11. *Having regard to the above, it is clear that the trust exists to produce profits (including in the form of unrealised gains) from buying, holding and disposing of securities for the purpose of making regular distributions to unitholders. The manner and extent of the trading activities undertaken by the trustee are consistent with this purpose. Together, these factors on balance support the conclusion that the gains and losses on disposal of securities are on revenue account.*

Example 2: testamentary trust

12. *Y is the trustee of a testamentary trust established for the benefit of the deceased's incapacitated spouse. The value of the trust estate is around $1 million. Although there is no explicit portfolio management style, Y manages the portfolio in a commercial and businesslike manner. Accordingly, Y will on occasion sell shares included in the portfolio – the annual portfolio turnover is approximately 10%.*

13. *Under the deceased's will, Y is directed to hold and invest the estate and to apply the income for the spouse's benefit during her lifetime with the capital passing on the spouse's death to other members of the family. In the years in question the spouse is middle aged and her medical expenses substantial.*

14. *Having regard to the terms of the will and the personal circumstances of the spouse, it would appear that the trustee is under a duty to ensure the real value of the capital is preserved so as to produce an income stream adequate to maintain the spouse over her lifetime and not disadvantage the residuary beneficiaries.*

15. *While the manner and extent of the trading activities might support an inference that the trustee is in the business of investing, the nature of the trust and the trustee's duties, on balance, would support the conclusion that the gains and losses on disposal of the shares are on capital account.*

Example 3: add-value and exit investment strategy

16. *Z is the trustee of a trust established for a period of 10 years. The trust deed defines the trust's investment strategy by reference to the information memorandum issued to investors.*

17. *The information memorandum indicates that the trust will acquire a majority shareholding in one or more companies, actively manage those companies to add to their value and then sell the shares at a profit when a specified rate of return has been reached (usually within 3 to 5 years).*

18. *The information memorandum states that the trust is speculative, illiquid and a risky investment, and that the principal return to unitholders will be sourced in the profit anticipated upon the sale of the trust's assets.*

19. *In accordance with the trust's investment strategy, directors are appointed to the companies' boards and acquired companies are actively managed with a view to their value increasing, for example by leverage, restructuring or asset sales.*

20. *All of the shareholdings in the acquired companies are sold within 5 years, and some within 12 months, of acquisition.*

21. *Having regard to the information memorandum and the trustee's duties under the trust deed, it is clear that the trust exists for the purpose of generating a return to investors from profit making undertakings involving the acquisition and disposal of the target companies. In these circumstances, the gains and losses on the sale of the shares in the relevant companies would be on revenue account.*

Example 4: family trust

22. *John is a successful architect in private practice. He established a family trust some years ago, the trustee of which is a company, the directors of which are himself and his wife. The beneficiaries of the trust include John, his wife and their children and other associated family entities.*

23. *His object in setting up the trust was to establish a fund which would have flexibility to assist the family in its varying needs and ultimately to help provide for himself and his wife in their retirement.*

24. *Under the trust deed the trustee has a broad discretion whether to distribute income of a particular year or to accumulate it. If the trustee exercises the power to distribute then it may appoint the income amongst the named beneficiaries in such amounts as it alone may determine. Upon termination of the trust (after 80 years) John and his wife are entitled to the capital of the trust in equal shares, including any income which has been accumulated.*

25. *With this in mind the trustee invested in securities which had a prospect of growing in value, hopefully above the inflation rate, and at the same time provided a reasonable income flow.*

26. *John and his wife, as directors of the trustee company, meet with their stockbroker two or three times a year to review the investments, and make any changes the broker recommends. In addition the broker will occasionally ring to suggest either that some particular security is encountering business difficulties, recommending that it be sold, or that another security is one in which they should consider investing. John also rings the broker from time to time to discuss the merits of particular stocks he has read about in investment newsletters.*

27. *Over the years, the level of switching between stocks has generally been no more than 4 to 5% of the value of the total portfolio. However in November 2007, the broker advised that it would be prudent, with a view to preserving the value of the trust assets and the continuing income flow to sell a substantial number of stocks which the broker considered would be adversely affected by a likely economic downturn. John and his wife took this advice and invested in more defensive stocks and government bonds. This resulted in changes to some 25% of the value of the portfolio.*

28. *The nature of the trust and the trustee's duties do not point strongly to either a revenue or capital account characterisation. Given this, and having regard to the extent to which, and the circumstances in which, the trustee chose to switch between stocks, including the unusual circumstances that led to the large changes to the portfolio in 2007, the better view is that the disposals represented the mere realisation of capital assets and hence the corresponding gains or losses are on capital account.*

29. *If, on the other hand, the trustee had adopted an investment approach which involved it systematically selling its stocks when certain criteria were met, and if the switching of stocks was a sufficiently frequent occurrence, then together those factors would tend to indicate that the gains and losses on disposal of the stocks would be on revenue account.*

Example 5: property investment trust

30. *The Prestige Office Property Trust was established in 2000 and is due to be wound up in 2020. The trust's property currently consists of five quality office buildings, in geographically diverse locations with a variety of different tenants. The trustee is authorised to acquire additional properties, the acquisition being funded by debt and unit application monies subscribed by investors. The trust is not a managed investment trust for the purposes of Subdivision 275-A of the ITAA 1997.*

31. *The trust was established with the aim of providing unitholders with a stable income stream and potential capital growth. The trustee does this by pursuing properties that require repositioning, re-leasing or refurbishing with a view to increasing rental income, which ultimately drives increases in capital value.*

32. *The net rental income is paid to unitholders in proportion to their respective unitholdings by way of quarterly distributions. Although the unrealised gains on the office buildings are recognised for accounting purposes, such gains are not distributable to unitholders.*

33. *The trustee invests in properties for the long term. Consistent with this the trustee has not previously disposed of any properties and does not actively monitor property values with a view to 'switching' investments. In particular, the investment strategy for the trust does not contain benchmarks for determining when properties should be disposed of.*

34. *In 2010, the trustee is approached by a developer (an unrelated entity) that plans to develop a large business park over a number of properties including one owned by the trustee. The trustee is offered a price for the property which is well above that likely to be received from the sale of the property as an office building.*

35. *The board of directors approves the sale given the exceptional return for investors. On this occasion the gain realised on the disposal of the property is distributed to unitholders in proportion to their unitholdings.*

36. *The relevant facts and circumstances, including the purpose for which the trust was established, the fact that the trustee acquired its properties primarily to produce rental income, and the manner in which the sale came about, would support the gain from the sale of the property being on capital account.*

37. *If, on the other hand, the trustee had adopted an investment approach which involved it systematically selling properties when certain criteria were met, this would point to the gain instead being on revenue account.*

Date of effect

38. This Determination applies to years of income commencing both before and after its date of issue. However, this Determination will not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of this Determination (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10).

39. However section 275-10 of the *Income Tax (Transitional Provisions Act) 1997* (IT(TP)A 1997) limits the Commissioner's ability to amend an assessment for a year of income prior to the 2008-09 income year to treat a gain or loss from an asset as being on revenue account or on capital account in certain circumstances relating to Managed Investment Trusts.

Commissioner of Taxation
17 August 2011

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.

Explanation

40. A trustee may from time to time make gains or losses from the disposal of investments (for example, shares, units or real estate) held on trust for relevant beneficiaries. In the absence of a contrary legislative provision, the character of a gain or loss must be determined having regard to all of the relevant facts and circumstances.

41. If, on the facts, a disposal of an investment by a trustee amounts to no more than a mere realisation or change of investment, the gain or loss will be on capital account. But if, on an assessment of all the facts, including the nature of the trust and the content of the trustee's duties, the disposal of the investment is a normal operation in the course of carrying on a business of investment, any gain will be income according to ordinary concepts and any loss deductible (*London Australia Investment Co Ltd v. Federal Commissioner of Taxation* (1977) 138 CLR 106; 77 ATC 4398; (1977) 7 ATR 757 (*London Australia*)).

42. Similarly, a profit or gain from a transaction will be income if:

- the trustee entered into the transaction to make a profit or gain; and
- the transaction was entered into, and the profit was made, either outside the normal course of the taxpayer's business, or in the carrying out of an isolated or one-off business operation or commercial transaction (*Federal Commissioner of Taxation v. The Myer Emporium Ltd* (1987) 163 CLR 199; 87 ATC 4363; (1987) 18 ATR 693).[4]

43. Some commentators have taken observations made by the High Court in *Charles v. Federal Commissioner of Taxation* (1954) 90 CLR 598; (1954) 10 ATD 328 (*Charles*) and in *London Australia* as suggesting that trustees are incapable of making gains on revenue account because the changing of investments by a trustee will always be a necessary incident of the trustee's fiduciary duty to preserve for beneficiaries as far as practicable the assets comprising the trust fund and any increments in the value of those assets.

44. In *Charles*, however, the finding that the gains on the realisation of investments were gains made on capital account was based largely on the unchallenged evidence from the managers of the trust that at no time were securities acquired for the express purpose of re-sale at a profit and that sales were normally made when the managers anticipated a fall in the value of shares. Moreover, as the High Court has recently emphasised in the context of a discussion relating to *Charles* and authorities cited therein, decisions should not be attributed a general significance which they may not have, given the particular facts upon which they were decided.[5]

45. The extent, if any, to which the ownership of investments by a trustee affects the characterisation of the trustee's activities as a business was considered more recently by the *Full Federal Court in FC of T v. Radnor Pty Ltd* 91 ATC 4689; (1991) 22 ATR 344 (*Radnor*).

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[4] The treatment of isolated profits is discussed in more detail in Taxation Ruling TR 92/3.

[5] See for example, *CPT Custodian Pty Ltd v. Commissioner of State Revenue* (2005) 224 CLR 98; 2005 ATC 4925; (2005) 60 ATR 371 – at paragraph 35.

46. That case involved a taxpayer company which, while not a trustee, was used as the vehicle for the investment of the funds of three trusts. The three trusts had been established and maintained primarily to ensure that a disabled person would receive adequate care for the rest of his life.

47. The need to ensure the availability of funds for the disabled person, who could at any time have required full time institutional care for the foreseeable future, underlay the entire investment philosophy of the taxpayer company. This fact was fundamental to the conclusion that the taxpayer was not carrying on a business.

48. Hill J in *Radnor* at ATC 4699; ATR 355, citing the decision of the High Court in *Official Receiver in Bankruptcy (Fox's Estate) v. Federal Commissioner of Taxation* (1956) 96 CLR 370, observed that the mere fact that a taxpayer is a trustee could never be conclusive of the question whether a business is carried on by the taxpayer. Nevertheless, Hill J said at ATC 4700; ATR 356 that in determining whether an activity is properly to be characterised as a business activity it will be relevant that the activity is undertaken by a taxpayer in the position of a trustee who is obliged, in accordance with his obligation of prudence, to ensure that the value of the assets under his control are preserved for the benefit of its beneficiaries.

49. The characterisation of a trustee's activities is one of fact and degree. In making the wide survey and exact scrutiny of those activities to which the Court in *Western Gold Mines NL v. Commissioner of Taxation* (WA) (1938) 59 CLR 729 at 740 referred, the nature of the trustee's powers and obligations are merely one of the factors to be considered.

50. In *Radnor* Gummow J said at ATC 4691; ATR 346:

> ...Much depends upon the nature of the trust in question. Express trusts take many forms and serve a variety of purposes. The content of the duties of the trustee will vary according to the nature and terms of the powers vested in the trustee. There has been a long history of the conduct of trading activities by the medium of trustees ... If such trustees are authorised or directed by the constituent documents, or, in a given case, by the beneficiaries, to conduct speculative activities or otherwise to engage in a business, then the content of their duties is to be ascertained with that in mind.

51. In *Radnor* Hill J at ATC 4698 to 4699; ATR 355 referred to the decision in *Charles* as follows:

> The trust deed provided that, except for the purposes of the deed, the trustees should not sell any investments until the determination of the trust. Nevertheless the deed did give the trustees a wide power to vary investments. The court, on the evidence before it which included the provisions of the trust deed, saw the case as one where the transactions were effected in the course of the trustee's fiduciary obligations to the beneficiaries to preserve for them the trust assets and increments thereto, rather than as a case where the trustees were carrying on a business of 'stock jobbing'. Nevertheless, Dixon CJ, Kitto and Taylor JJ said (at ATD 331; CLR 610):
>
> > if the proper conclusion from the evidence were that the managers and the trustees co-operated in pursuing a systematic course of buying and selling securities for the purpose of producing profits and thereby swelling the half-yearly amounts of 'cash produce' available for distribution to certificate-holders, the Commissioner's opinion that such profits should be treated as assessable income of the certificate-holders when paid over to them would be clearly correct.

52. Thus, for instance, if, 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, then that fact may lend support to a conclusion that the profits are made on revenue account.

53. On the other hand, if trustees are authorised or directed to ensure that the value of the assets under their control, including any increments thereto, are preserved for the long term in order, for example, to provide lifetime support for an incapacitated person, then that would lend support to a conclusion that the investments are held on capital account.

54. The nature of the trust and the terms and content of the trustee's duties must be determined having regard to all relevant circumstances, including the events surrounding the establishment of the trust, the trust instrument and associated information such as a prospectus. It may also be relevant, as discussed in *Orr v. Wendt & Ors* [2005] WASCA 199 (at paragraph 46), to examine:

- whether there are different classes of beneficiaries with competing interests;
- the nature of the assets comprising the trust fund;
- the professional expertise of the trustee and its advisors; and
- the personal circumstances of the relevant beneficiaries (for example, whether they are investors or family members of the settlor, if they are investors what expectations they have about returns from the trust, and if they are family members whether they depend on trust distributions for their livelihood).

55. In characterising whether a gain or loss has been made on revenue or capital account, the nature of the trust and the terms and content of the trustee's duties must be weighed together with any other relevant factors which would assist in determining whether the gain or loss was made in the ordinary course of carrying on a business of investment or as a result of a transaction entered into with a profit making purpose in the course of carrying out a business operation or commercial transaction.

56. Factors which tend to support a capital account conclusion would include:

- the absence of an investment style which envisages an exit point – for example the trustee adopts a 'buy and hold' style of investment;[6]
- a low average annual turnover – that is, less than in London Australia where turnover had been in the order of 10%;
- a lack of regularity in the particular sale activity – *AGC (Investments) Limited v. FC of T* (1992) 23 ATR 287; 92 ATC 4239 (*AGC Investments*); *Trent Investments Pty Ltd v. FC of T* 76 ATC 4105; (1976) 6 ATR 201;
- a high proportion of those stocks that are sold have been held for a significant number of years (see *AGC Investments* where 75% of stocks sold was held more than 5 years). However, if a high proportion of the remainder are then also turned over, this tends to support the opposite conclusion;
- a low level of sales transactions compared with the number of stocks in the portfolio – see *Milton Corporation Ltd v. FC of T* 85 ATC 4243; (1985) 16 ATR 437;
- profits on sale normally only constitute a small percentage of total income;

[6] Contrast a 'value style' of investment which envisages the purchase of undervalued shares and their subsequent sale when they become fully valued by the market.

- significant percentage of 'aged' stocks remain in the portfolio (see *AGC Investments* where nearly 60% of remaining stocks had been held more than 10 years); and
- the existence of a family as distinct from a commercial explanation for the dealing.

57. The relevance of any one of these factors may depend on the nature and/or scale of the operation or transaction(s) under examination. In a particular factual situation, a single factor may have little or no relevance. For example, where a trust is set up to acquire a particular company, actively add to its value, and sell it, the fact that the shares in that company are not regularly turned over would have little or no relevance to the characterisation of any profit made on the disposal of the shares in that company. Further, a particular factor may have different significance in different factual contexts. For example, where share trades are made in the context of a large share portfolio, a particular rate of turnover may have a different significance than it would have in the context of a small portfolio.

Contrary legislative intention for certain managed investment trusts

58. Section 275-115 of the ITAA 1997 enables the trustee of a managed investment trust to irrevocably choose to apply the CGT provisions as the primary code for taxation of gains and losses from certain assets (shares, units, land and / or options or rights in respect of any of these).

59. If there is a capital treatment election in force for the 2008-09 income year, there are rules in section 275-10 of the IT(TP)A 1997 that limit the Commissioner's ability to amend an assessment for a year of income prior to the 2008-09 income year to treat a gain or loss from an asset as being on revenue account or on capital account.

60. However a gain or loss of a managed investment trust will be characterised in accordance with this Determination if:

- the trustee has made an irrevocable election for capital account treatment in one year but the trust does not satisfy the definition of a managed investment trust in a subsequent income year in which it makes a gain or loss from a CGT event – see paragraph 275-100(1)(b) of the ITAA 1997;
- the gain or loss relates to assets not covered by section 275-105 of the ITAA 1997 – see paragraph 275-100(1)(d) of the ITAA 1997;
- the trust is a corporate unit trust or trading trust in an income year in which it makes a gain or loss from a CGT event (regardless of whether the trustee has made an irrevocable election for capital account treatment) – see paragraph 275-100(1)(e) of the ITAA 1997; and
- the trust is a managed investment trust that has not elected for capital account treatment and the gain or loss is from land – see paragraph 275-120(1)(b) of the ITAA 1997. Gains from other assets covered by section 275-105 made by the trustee of a managed investment trust that has not elected for capital account treatment will be treated as being on revenue account – see subsection 275-120(2) of the ITAA 1997.

References

Previous draft:

TD 2011/D1

Related Rulings/Determinations:

TR 92/3; TR 2006/10

Subject references:

- trusts
- characterisation of gains
- characterisation of losses
- capital gains
- revenue gains
- capital losses
- revenue losses
- unit trusts
- investment trusts
- investment income

Legislative references:

- ITAA 1997
- ITAA 1997 Subdiv 275-A
- ITAA 1997 275-100
- ITAA 1997 275-100(1)
- ITAA 1997 275-100(1)(b)
- ITAA 1997 275-100(1)(d)
- ITAA 1997 275-100(1)(e)
- ITAA 1997 275-105
- ITAA 1997 275-115
- ITAA 1997 275-120(1)
- ITAA 1997 275-120(1)(b)
- ITAA 1997 275-120(2)
- ITAA 1997 295-85
- ITAA 1997 394-30(7)
- IT(TP)A 1997
- IT(TP)A 1997 275-10
- TAA 1953

Case references:

- AGC (Investments) Ltd v. FC of T 92 ATC 4239; (1992) 23 ATR 287
- Charles v. Federal Commissioner of Taxation (1954) 90 CLR 598; (1954) 10 ATD 328
- CPT Custodian Pty Ltd v. Commissioner of State Revenue (2005) 224 CLR 98; 2005 ATC 4925; (2005) 60 ATR 371
- Federal Commissioner of Taxation v. The Myer Emporium Ltd (1987) 163 CLR 199; 87 ATC 4363; (1987) 18 ATR 693
- FC of T v. Radnor Pty Ltd 91 ATC 4689; (1991) 22 ATR 344
- London Australia Investment Co Ltd v. Federal Commission of Taxation (1977) 138 CLR 106; 77 ATC 4398; (1977) 7 ATR 757
- Milton Corporation Ltd v. FC of T (1985) 85 ATC 4243; (1985) 16 ATR 437
- Official Receiver in Bankruptcy (Fox's Estate) v. Federal Commissioner of Taxation (1956) 96 CLR 370
- Orr v. Wendt & Ors [2005] WASCA 199
- Trent Investments Pty Ltd v. FC of T 76 ATC 4105; (1976) 6 ATR 201
- Western Gold Mines NL v. Commissioner of Taxation (WA) (1938) 59 CLR 729

ATO references

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