



TD 2012/11 - Income tax: capital gains: for the purposes of subsection 115-228(1) of the Income Tax Assessment Act 1997, can a beneficiary of a trust estate be reasonably expected to receive an amount of a financial benefit referable to a capital gain made by the trust estate in an income year if the fact that the capital gain was made is not established until after the end of the income year?

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Taxation Determination

Income tax: capital gains: for the purposes of subsection 115-228(1) of the *Income Tax Assessment Act 1997*, can a beneficiary of a trust estate be reasonably expected to receive an amount of a financial benefit referable to a capital gain made by the trust estate in an income year if the fact that the capital gain was made is not established until after the end of the income year?

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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, 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. Yes, it is possible (depending on the circumstances) for a beneficiary of a trust estate to be reasonably expected to receive an amount of a financial benefit referable to such a gain for the purposes of subsection 115-228(1) of the *Income Tax Assessment Act 1997* (ITAA 1997), despite the making of the capital gain not being established until after the end of the income year. The reasonable expectation requirement is directed to the future receipt by the beneficiary of an amount referable to the gain should it arise, not to the likelihood of the gain itself being made.

Example 1 – conditional contract

2. In November 2011 the Trustee of the Bottomley Trust enters into a binding contract for the sale of shares with settlement to take place in November 2016. The contract contains a number of conditions which must be fulfilled before either party to the contract is obliged to complete. Therefore, although there is an immediately binding contract which creates rights and obligations capable of enforcement, the contract is subject to the fulfilment of conditions subsequent to its formation. Accordingly, the obligation of the parties to perform is contingent on the fulfilment of the conditions and non-fulfilment confers a right to terminate.

3. Because the completion of the contract is contingent upon the fulfilment of these conditions, there is a chance that the contract will not settle. Accordingly, when the contract is entered into, there is no certainty that a change of ownership of the shares will occur such that CGT event A1 will happen. However if the contract does settle in November 2016, CGT event A1 will happen (and the gain will be recognised for tax purposes) in November 2011, when the contract was entered into.

4. If the contract is completed, the sale proceeds will form part of the capital of the Bottomley Trust. In a valid exercise of a power under the trust deed to distribute capital, the trustee of the Bottomley Trust resolves (by 31 August 2012) to distribute to a beneficiary, Potts Pty Ltd, all of the net financial benefit referable to any capital gain arising on the disposal of the shares.

5. Subdivision 115-C of the ITAA 1997 applies where there is a net capital gain of a trust estate included in the net income of that trust. It then looks to each capital gain made by the trust estate. Should the contract settle and result in a capital gain of the Bottomley Trust, Potts Pty Ltd will have satisfied the requirement under paragraph (a) of the definition of 'share of net financial benefit' in subsection 115-228(1) of the ITAA 1997 by 31 August 2012, that it can be reasonably expected to receive a share of the net financial benefit referable to the capital gain.

6. The fact that the happening of CGT event A1 (and the making of a capital gain) is contingent upon the completion of the contract for sale does not preclude Potts Pty Ltd from demonstrating a reasonable expectation of receiving the financial benefit referable to the capital gain if any (that is, if the contract completes). The trustee resolution to distribute an amount equal to the net financial benefit referable to the capital gain founds a reasonable expectation of Potts Pty Ltd receiving that amount should the contract complete.

Note: The wording of the resolution is sufficient to make Potts Pty Ltd specifically entitled to the net financial benefit arising from the capital gain (if any) arising on any disposal of the shares (including, for example, if the contract entered into in November 2011 does not complete, but a subsequent contract does).

Example 2 – deferred settlement

7. The deed establishing the Battersea Trust defines the income of the trust for a given income year as meaning the net income of the trust for that year determined in accordance with subsection 95(1) of the Income Tax Assessment Act 1936, with certain exceptions not relevant for present purposes. The trustee of the Battersea Trust has a discretion to appoint the income of the trust amongst a range of discretionary objects. If the trustee fails to appoint the income by 30 June in any year, that income is to be held for Pimlico Pty Ltd.

8. *In June 2012, the trustee enters into a binding contract to sell land with settlement to take place in September 2012. Any gain (should it arise) will not be a discount capital gain.*

9. *In August 2012, the trustee of the Battersea Trust resolves to distribute to a beneficiary, Chelsea, all of the net financial benefit referable to any capital gain arising on the disposal of the land under the June 2012 contract. The trustee makes no other appointments of income or capital.*

10. *Upon the failure of the trustee to make any appointment of income by 30 June 2012, pursuant to the deed, the default beneficiary Pimlico Pty Ltd became presently entitled to all of the income of the trust for the 2012 income year (including the capital gain). The deed therefore founds a reasonable expectation of Pimlico Pty Ltd receiving the financial benefit referable to the gain made by the Battersea Trust on disposal of the land should the contract complete.*

11. *Despite the resolution, there can be no reasonable expectation of Chelsea receiving that amount. This is because another beneficiary has already been made presently entitled to that amount.*

Note: If there was no default beneficiary and instead the deed provided that any income the trustee failed to distribute by 30 June 2012 would form part of the trust fund, the August 2012 resolution would found a reasonable expectation of Chelsea receiving the net financial benefit referable to any capital gain arising on the disposal of the land, as long as the trustee was empowered to make such capital distributions to her.

Example 3 – no contract yet in contemplation

12. *The trust deed for the Morse Trust provides that Hercules is entitled to receive all of the income and any gains or proceeds in respect of shares held in Dairy Pty Ltd.*

13. *Accordingly, the deed establishes a reasonable expectation of Hercules receiving the financial benefit referable to any capital gain that is made by the trust estate in respect of those shares.*

Date of effect

14. 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).

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

15. Amendments made by *Tax Laws Amendment (2011 Measures No. 5) Act 2011* ensure that, where permitted by the trust deed, capital gains and franked distributions can be effectively streamed to beneficiaries for tax purposes by making them 'specifically entitled' to those amounts.

16. If a trust estate makes a capital gain, section 115-228 of the ITAA 1997 sets out the amount (if any) of that gain to which a beneficiary of the trust is treated as being specifically entitled.

17. Applying the formula in subsection 115-228(1) of the ITAA 1997, to be specifically entitled to an amount of a capital gain made by the trust estate, a beneficiary must identify their relevant 'share of the net financial benefit'. This is defined to mean the amount equal to the financial benefit¹ that, in accordance with the terms of the trust, including in accordance with the exercise of a power conferred by the terms of the trust:

- the beneficiary has received or can be reasonably expected to receive (paragraph (a) of the definition);
- is referable to the capital gain (paragraph (b) of the definition); and
- is recorded in its character as an amount referable to the capital gain in the accounts or records of the trust within 2 months after the end of the income year (paragraph (c) of the definition).

18. The requirement that a beneficiary be 'reasonably expected to receive' an amount equal to a financial benefit does not focus on whether the beneficiary has a reasonable expectation of the relevant capital gain arising. The provision is premised on there being such a gain. Accordingly, the requirement instead focuses on whether the beneficiary has a reasonable expectation of receiving an amount referable to that gain (should the gain arise).

19. When a CGT asset is disposed of under a contract, CGT event A1 happens when the contract was entered into (paragraph 104-10(3)(a) of the ITAA 1997) and not when the contract settles and the change of ownership of the asset occurs. A contract entered into in one income year may settle in a later income year.

20. However, satisfying the 'reasonably expected to receive' test is not directed to the likelihood of the disposal occurring and does not require an expectation that the disposal will occur. Rather, the test is whether, assuming there is a disposal that gives rise to a capital gain, there is a reasonable expectation that an amount of a financial benefit that is referable to any such capital gain made by the trust estate will be received by the beneficiary.

21. The expression 'reasonably expected' is not defined for the purposes of the ITAA 1997 and accordingly takes its ordinary meaning in the context in which it appears.

¹ Financial benefit is defined in section 974-160 of the ITAA 1997.

22. In *Peabody v. Commissioner of Taxation* (1993) 40 FCR 531; 93 ATC 4104; (1993) 25 ATR 32, Hill J found that the expression 'reasonable expectation', in the context of the anti-avoidance rules contained in Part IVA of the *Income Tax Assessment Act 1936*, was also intended to receive its ordinary meaning. His Honour held at FCR 541; ATC 4112; ATR 40 that:

... the expectation must be one which is reasonable and not one which is unreasonable, irrational or absurd.....The word 'expectation' requires that the hypothesis be one which proceeds beyond the level of a mere possibility to become that which is the expected outcome.

23. On appeal, the full High Court in *Federal Commissioner of Taxation v. Peabody* (1994) 181 CLR 359 at 385; 94 ATC 4663 at 4671; (1994) 28 ATR 344 at 353, also noted that a reasonable expectation requires more than a possibility – and therefore involves a prediction that must be sufficiently reliable for it to be regarded as reasonable.

24. Whilst neither Court expressly referred to the dictionary meaning of the words making up the composite expression 'reasonable expectation', the interpretation they adopted is nevertheless consistent with the defined meaning of those words. For example, *The Macquarie Dictionary*² defines 'reasonable' as meaning 'endowed with reason'. 'Reason' is relevantly defined to mean:

1. a ground or cause, as for a belief, fact, event;
2. a statement in justification.

25. It follows that the adverb 'reasonably' connotes that the expectation must be one that can be justified in the sense that it is based on a ground or a cause.

26. The verb 'expect' is relevantly defined as:

1. to look forward to; regard as likely to happen;
2. to look for with reason or justification.

27. A beneficiary can therefore establish a reasonable expectation of receiving an amount referable to a capital gain in the context of paragraph (a) of the definition of 'share of net financial benefit' in subsection 115-228(1) of the ITAA 1997 if there are grounds to justify an expectation that, in accordance with the terms of the trust, the receipt of the amount (should such a gain be made) is likely. Adapting the language of Hill J and the full High Court in the *Peabody* decisions referred to above, it follows that a reasonable expectation of receipt of the amount (should the capital gain be made by the trust estate) is an expected outcome that is reliably based, rather than one that is a mere possibility. Logically, it necessarily excludes a predicted outcome that is unreasonable, irrational or absurd.

28. A valid resolution by the trustee in accordance with the terms of the trust deed to distribute an amount to a beneficiary that is referable to a capital gain made by the trust estate (in the event that a capital gain is made), without more, founds a reasonable expectation of receiving the amount. If other circumstances exist which suggest to the beneficiary that they will not receive that amount should it arise (such as, say, that the resolution is a sham or it can be reasonably expected that the resolution will be revoked, if indeed this is possible), those circumstances may be such as to prevent the resolution, in light of those circumstances, being sufficient to found a reasonable expectation of receiving that amount. However, the Commissioner expects that such circumstances would be unusual.

² *The Macquarie Dictionary*, [Multimedia], version 5.0.0, 1/10/01.

29. For a reasonable expectation of receiving the financial benefit referable to a capital gain to be founded by valid resolution by the trustee, the capital gain does not need to have already been realised by the trust at the time the resolution is made nor is it necessary that there be certainty that the gain will arise. It is sufficient that the resolution is in respect of an anticipated capital gain on the disposal of a CGT asset that may not take place until a later income year. This position is confirmed in Example 2.1 of the Explanatory Memorandum to the Tax Laws Amendment (2011 Measures No. 5) Bill 2011.

30. Likewise, if the terms of the trust deed require the amount of a capital gain made by the trust estate in respect of particular assets to be distributed to a specified beneficiary, without more, the beneficiary demonstrates a reasonable expectation of receiving the amount in the event that a capital gain is made. If other circumstances exist which suggest to the beneficiary that they will not receive that amount should it arise (such as, say, that the deed is likely to be varied to alter this entitlement), those circumstances may be such as to prevent the deed, in light of those circumstances, being sufficient to found a reasonable expectation of receiving that amount. However, the Commissioner expects that such circumstances would be unusual.

Extra requirement to be specifically entitled – recording

31. If the amount the beneficiary is reasonably expected to receive is also recorded (in accordance with paragraph (c) of the definition of 'share of net financial benefit') in its character as an amount referable to the capital gain in the accounts or records of the trust within 2 months after the end of the income year in which the capital gain is made, the beneficiary is specifically entitled to an amount of the capital gain as calculated under section 115-228.

32. Note however that if the amount referable to a capital gain made by a trust estate forms part of the income of that trust, the 2 month recording period may have no practical relevance. This is because some deeds require all of the income of the trust to be distributed by the end of each income year or, failing distribution, to be held from that time for particular beneficiaries named in the deed.

33. In those circumstances, a beneficiary intended to be specifically entitled to a capital gain (by virtue of a trustee resolution made after the end of the income year) can have no reasonable expectation of receiving amounts referable to that gain if another beneficiary has already been made presently entitled to those amounts (by virtue of the deed itself).

References

Previous draft:

TD 2012/D2

Related Rulings/Determinations

TR 2006/10

Subject references:

- capital gains tax
- CGT assets
- CGT event A1 – disposal of a CGT asset
- CGT trust distributions
- trust beneficiaries
- trust deeds
- trusts

Legislative references:

- ITAA 1936 Pt IVA
- ITAA 1936 95(1)
- ITAA 1997 104-10(3)(a)
- ITAA 1997 Subdiv 115-C
- ITAA 1997 115-228

- ITAA 1997 115-228(1)
- ITAA 1997 974-160
- Tax Laws Amendment (2011 Measures No. 5) Act 2011

Case references:

- Federal Commissioner of Taxation v. Peabody (1994) 181 CLR 359; 94 ATC 4663; (1994) 28 ATR 344
- Peabody v. Commissioner of Taxation (1993) 40 FCR 531; 93 ATC 4104; (1993) 25 ATR 32

Other references:

- Explanatory Memorandum to the Tax Laws Amendment (2011 Measures No. 5) Bill 2011
- The Macquarie Dictionary, [Multimedia], version 5.0.0, 1/10/01

ATO references

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