TD 2012/D2 - Income tax: capital gains: for the purposes of paragraph 115-228(1)(a) of the Income Tax Assessment Act 1997 can a beneficiary of a trust estate be reasonably expected to receive a share of the net 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?

This document has been finalised by TD 2012/11.

There are Compendiums for this document: **TD 2013/21EC** and **TD 2012/11EC** .

Draft Taxation Determination

Income tax: capital gains: for the purposes of paragraph 115-228(1)(a) of the *Income Tax Assessment Act 1997* can a beneficiary of a trust estate be reasonably expected to receive a share of the net 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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Ruling

1. Yes, it is possible (depending on the circumstances) for a beneficiary of a trust estate to be reasonably expected to receive a share of the net financial benefit referable to such a gain for the purposes of paragraph 115-228(1)(a) 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 of an amount referable to the gain should it arise, not to the likelihood of the gain itself occurring.

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 contact is entered into, there is no certainty that a change of ownership of the shares will occur such that CGT event A1 will happen.*

4. *If the contract is completed, the sale proceeds will form part of the capital of the Bottomley Trust.*

5. *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 in the event the contract proceeds to completion. The deed provides that trustee resolutions made in accordance with the deed are irrevocable.*

6. *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 satisfy the requirement under paragraph 115-228(1)(a) of the ITAA 1997 that it can be reasonably expected to receive a share of the net financial benefit referable to the capital gain.*

7. *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 should the contract complete. 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.*

Example 2 – deferred settlement

8. *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.*

9. *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.*

10. *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 in the event that the contract proceeds to completion. The trustee makes no other appointments of income.*

11. *Upon the failure of the trustee to make any appointment of income by 30 June 2012, pursuant to the deed, 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.*

12. *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.*

Example 3 – no contract yet in contemplation

13. *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. The trustee has no power to vary the terms of the trust.*

14. *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

15. When the final Determination is issued, it is proposed to apply both before and after its date of issue. However, the Determination will 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 Determination (see paragraph 75 to 77 of Taxation Ruling TR 2006/10).

Commissioner of Taxation
1 February 2012

Appendix 1 – Explanation

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

Explanation

16. 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.

17. Where a trust estate has made 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 will be treated as being specifically entitled.

18. Under that provision, there are two requirements that must be satisfied in order for a beneficiary to be specifically entitled to an amount of a capital gain made by a trust. They are 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 an amount equal to the financial benefit that is referable to the capital gain (paragraphs 115-228(1)(a) and (b) of the ITAA 1997); and
- the beneficiary's entitlement 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 115-228(1)(c) of the ITAA 1997).

19. The requirement in section 115-228 of the ITAA 1997 that a beneficiary be 'reasonably expected to receive an amount' referable to the capital gain does not focus on whether the beneficiary has a reasonable expectation of the 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 referrable to that gain (should it arise).

20. 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.

21. 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 referable to any such capital gain made by the trust estate will be received by the beneficiary.

22. 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.

23. 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.

24. 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.

25. 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*[1] 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.

26. 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.

27. 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.

28. A beneficiary can therefore establish a reasonable expectation of receiving an amount referable to a capital gain in the context of paragraph 115-228(1)(a) 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.

29. A valid and irrevocable 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) founds a reasonable expectation of receiving the amount in terms of paragraph 115-228(1)(a) of the ITAA 1997.

30. 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.

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

31. 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, the beneficiary demonstrates a reasonable expectation of receiving the amount in the event that a capital gain is made.

Extra requirement to be specifically entitled – recording

32. If the amount the beneficiary is reasonably expected to receive is also recorded (in accordance with paragraph 115-228(1)(c) of the ITAA 1997) 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 will be specifically entitled to an amount of the capital gain as calculated under section 115-228.

33. 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.

34. 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).

Appendix 3 – Your comments

35. You are invited to comment on this draft Determination. Please forward your comments to the contact officer by the due date.

36. A compendium of comments is also prepared for the consideration of the relevant Rulings Panel or relevant tax officers. An edited version (names and identifying information removed) of the compendium of comments will also be prepared to:

- provide responses to persons providing comments; and
- publish on the Australian Taxation Office website at www.ato.gov.au

Please advise if you do not want your comments included in the edited version of the compendium.

Due date:	**2 March 2012**
Contact officer:	**Amanda Connolly**
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References

Previous draft:

Not previously issued as a draft

Subject references:

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

Legislative references:

- ITAA 1997 115-228
- ITAA 1997 115-228(1)(a)
- ITAA 1997 115-228(1)(b)
- ITAA 1997 115-228(1)(c)
- ITAA 1997 104-10(3)(a)
- ITAA 1997 Subdiv 115-C
- ITAA 1936 95(1)
- ITAA 1936 Pt IVA
- Tax Laws Amendment (2011 Measures No. 5) Act 2011

Case references:

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

Other references:

- The Macquarie Dictionary, [Multimedia], version 5.0.0, 1/10/01

ATO references

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