PS LA 2005/1 (GA) (Withdrawn) - Taxation of capital gains of a trust

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This Practice Statement is withdrawn from 13 October 2010. Please refer to the Decision Impact Statement for Federal Commissioner of Taxation of T v. Bamford & Ors [2010] HCA 10 and Law Administration Practice Statement PS LA 2010/1 for its applicability to the 2009-10 and earlier income years.

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Practice Statement Law Administration

PS LA 2005/1 (GA)

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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**

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

2. This practice statement applies if:

   (a) the proportionate approach to the taxation of the net income of a trust calculated under Division 6 of Part III of the *Income Tax Assessment Act 1936* (ITAA 1936) would result in an amount of capital gain being included in the share of net income of a beneficiary who does not have a vested and indefeasible interest in the amount of capital gain at the end of the income year and has not been allocated it; or

   (b) there is an amount of capital gain that would not be included in the share of net income of any beneficiary under Division 6 of Part III of the ITAA 1936, but there is a beneficiary who has a vested and indefeasible interest in the amount of capital gain at the end of the income year or has been allocated it.

3. This practice statement does not purport to offer any opinion as to the effectiveness or otherwise for income tax purposes of clauses in trust deeds that equate trust income with net income as calculated under section 95 of the ITAA 1936. Trusts with such clauses are within the scope of this practice statement if its terms can be satisfied on the facts.

Approaches the Commissioner will accept for paragraph 2(a) cases

4. In the circumstances described in paragraph 2(a) of this practice statement, the Commissioner will accept the following approaches to taxing the capital gain:

   (a) the proportionate approach described in paragraphs 5 to 7

   (b) the capital beneficiary approach described in paragraphs 8 to 9, or

   (c) the trustee approach described in paragraph 10.

Proportionate approach

5. In accordance with the 'proportionate approach' to the taxation of the net income of a trust, a beneficiary (or a trustee on their behalf) is assessed on a capital gain included in the net income of the trust in proportion to their interest in the trust income.

6. In addition, a beneficiary who is assessed under paragraph 97(1)(a), or under subsection 98A(1) because they are a beneficiary described in subsection 98(4), or under subsection 100(1) of the ITAA 1936, is treated as having an extra capital gain or gains for the purposes of subsection 115-215(3) of the *Income Tax Assessment Act 1997* (ITAA 1997) based on the capital gain included in their proportionate share of the net income of the trust.

   Note: A beneficiary who is treated as having extra capital gains is provided with a deduction for the amount of the capital gain assessed to them under paragraph 97(1)(a), subsection 98A(1) or subsection 100(1) of the ITAA 1936: subsection 115-215(6) of the ITAA 1997.

7. Assessing a capital gain to a trustee on behalf of a beneficiary or treating a beneficiary as having a capital gain or gains for the purposes of subsection 115-215(3) of the ITAA 1997 may be seen as unfair if the gain relates to an amount from which the beneficiary will not benefit. Accordingly, the capital beneficiary or trustee approach as set out below (or a combination of these approaches) can be applied to that beneficiary's share of the capital gain.

Capital beneficiary approach

8. The Commissioner will accept assessing a capital gain to a trustee on behalf of a beneficiary or treating a beneficiary as having a capital gain or gains for the purposes of subsection 115-215(3) of the ITAA 1997 to the extent that the beneficiary either has:

   - by the end of the income year, a vested and indefeasible interest in the trust capital representing the trust's capital gain (including if the trust's capital gain is less than the accounting gain) or, if the trust's capital gain is a 'deemed' amount for tax purposes, they would have had such an interest if the gain were represented by actual trust capital; or

- been allocated the trust's capital gain no later than two months after the end of the income year. In determining whether the trust capital gain has been allocated, the Commissioner will rely on the way the trustee characterises it.

9. In this practice statement 'the allocation of a capital gain' includes its crediting or distribution to a beneficiary, its payment or application on behalf of, or for the benefit of, a beneficiary or, in the case of a deemed capital gain, its allocation notionally by the trustee. An example of a deemed capital gain is one to the extent the market value substitution rule in section 116-30 of the ITAA 1997 applied to determine the capital proceeds.

Trustee approach

10. The Commissioner will also accept, for convenience, an assessment of the capital gain to the trustee under section 99 or 99A of the ITAA 1936. This is so whether or not the requirements for the capital beneficiary approach would also be met.

    Note: The requirements of the capital beneficiary approach would not be met if the capital beneficiaries have contingent or defeasible interests, or if their 'interests' are mere expectancies and the trustee's discretion has not been exercised in their favour.

Approaches the Commissioner will accept for paragraph 2(b) cases

11. In the circumstances described in paragraph 2(b) of this practice statement, the Commissioner will accept the following approaches to taxing the capital gain:

    (a) the trustee approach described in paragraph 12; or

    (b) the capital beneficiary approach described in paragraph 13.

Trustee approach

12. Ordinarily, if there is an amount of capital gain that would not be included in the share of net income of any beneficiary under Division 6 of Part III of the ITAA 1936, the trustee will be assessed under section 99A of the ITAA 1936 unless the Commissioner forms a view that it would be unreasonable for that section to apply. If the Commissioner forms such a view, the trustee is assessed under section 99 of the ITAA 1936.

Capital beneficiary approach

13. If there is a beneficiary who would satisfy the terms outlined in paragraph 8 in relation to the amount of capital gain, the Commissioner will accept, instead of the trustee approach, assessing the capital gain to a trustee on behalf of that beneficiary or treating that capital beneficiary as having capital gains for the purposes of subsection 115-215(3) of the ITAA 1997. If the capital beneficiary approach is not chosen, the approach in paragraph 12 will apply.

Requirements for various approaches in paragraph 2(a) and 2(b) cases

14. A capital beneficiary must agree in writing to use the capital beneficiary approach described in paragraphs 8 and 13. A capital beneficiary can only make such an agreement to the extent that they have a vested and indefeasible interest in the trust capital representing the capital gain at the end of the income year or have been allocated the capital gain.

    Example: A trust makes a capital gain of $10,000 that is reduced to $5,000 after the application of the CGT discount. There are two beneficiaries, X and Y, with a vested and indefeasible interest in the trust capital representing the trust's capital gain. X has a 70% interest and Y has a 30% interest in the capital of the trust. X can only agree to have $7,000 extra capital gains. This is calculated by grossing-up X's interest in the trust's capital gain ($5,000 x 70%) by two in accordance with paragraph 115-215(3)(b) of the ITAA 1997. Similarly, Y can only agree to have $3,000 extra capital gains. They cannot agree to have capital gains of a greater or lesser amount.

15. The trustee approach in paragraph 10 can be used only if all income beneficiaries who are presently entitled to the trust income for the particular income year, capital beneficiaries referred to in paragraph 8 and the trustee agree in writing to use it. The agreement of all parties in this circumstance is intended to provide a measure of protection to the trustee from claims by a beneficiary that the proportionate or capital beneficiary approach should have been adopted. (There is no requirement for an agreement to use the trustee approach outlined in paragraph 12).

16. If a beneficiary is a minor, the trustee can agree on their behalf to use the capital beneficiary or trustee approach. If a beneficiary is a subsidiary member of a consolidated group, then the head company of the group must be a party to an agreement in addition to the beneficiary entity.

17. Any agreement must be made no later than two months after the end of the relevant income year. However, the Commissioner may allow further time in special circumstances. 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.

18. For the 2004-05 income year, any trustee resolution allocating the capital gain and any agreement must be made before the end of 31 October 2005. However, where the trust has been granted leave to adopt a balancing date that ends after 30 June 2005 for the 2004-05 income year, and the two month period referred to in paragraph 17 would end after 31 October 2005, the relevant date is the end of the two month period.

19. If a party does not prepare their income tax return in accordance with an agreement (or challenges an assessment made in accordance with it) the Commissioner will ignore the agreement in assessing the capital gain. The business line should notify the Losses and Capital Gains Tax Centre of Expertise of such cases. Any issues relating to the remission of the shortfall interest charge, general interest charge or penalties must be determined on the facts of each case having regard to the ATO Receivables Policy and relevant practice statements.

20. The appendix contains a flowchart that summarises the application of this practice statement.

EXPLANATION

21. Under section 97 of the ITAA 1936, an Australian resident beneficiary, who is presently entitled to a share of trust income and not under a legal disability, 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. Paragraph 2(a) of this practice statement may apply in this case.

22. The trustee of a trust is assessed under section 98 of the ITAA 1936 on the share of net income of any beneficiary who is under a legal disability or is a non-resident at the end of an income year. These beneficiaries may also be assessed under sections 98A and 100 of the ITAA 1936 on their share of the net income of the trust, although they would be entitled to have regard to the tax paid by the trustee. Paragraph 2(a) of this practice statement may also apply in these cases (regardless of whether the beneficiary is also assessed).

23. If there is some net income of the trust not assessed as above, the trustee will be assessed in respect of it under section 99 or 99A of the ITAA 1936. Paragraph 2(b) of this practice statement may apply in this case.

24. Where a beneficiary is assessed, Subdivision 115-C of the ITAA 1997 may apply. It ensures that appropriate amounts of the trust's net income attributable to capital gains are treated as a beneficiary's capital gains so that the beneficiary can apply capital losses against the gains and apply the appropriate CGT discount percentage. This is explained in paragraph 25.

25. If a beneficiary's assessable income includes an amount of net income (that includes a capital gain) under paragraph 97(1)(a), subsection 98A(1) because subsection 98(4) applies to them, or subsection 100(1), then section 115-215 of the ITAA 1997 provides that the beneficiary is treated as having made an extra capital gain. (In some cases the beneficiary must 'gross up' the extra capital gain (by two or four) under paragraphs 115-215(3)(b) and (c) of the ITAA 1997.) Subsection 115-215(6) of the ITAA 1997 provides for a deduction so that an amount is not assessed under Division 6 of Part III of the ITAA 1936 and also treated as an extra capital gain.

26. The courts have determined that the 'share' of net income that must be included in the assessable income of a beneficiary 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*[1]. See also *Davis v. FC of T*[2]; *DCT v. Richard Walter Pty Ltd*[3] and *FCT v. Prestige Motors Pty Ltd*[4] (contrast Merkel J in *Richardson v. FC of T*[5]).

27. None of these cases expressly deals with the situation where the proportionate approach would lead to the assessment of a taxpayer who does not derive the benefit of the capital gain. Nor do the cases deal with a situation where there is a beneficiary who has been allocated, or has a vested and indefeasible interest in, the capital gain but there is either no trust income, or no beneficiary presently entitled to trust income.

[1] 98 ATC 4681 at 4693; (1998) 39 ATR 277
[2] 89 ATC 4377; 20 ATR 548; (1989) 86 ALR 195
[3] (1995) 29 ATR 644; (1995) 183 ALR 168; (1995) 69 ALJR 223; 95 ATC 4067
[4] (1994) 27 ATR 160; (1993) 118 ALR 497; (1993) 47 FCR 138; 93 ATC 5021
[5] 97 ATC 5098; (1997) 150 ALR 167; 37 ATR 452; (1997) 80 FCR 58

28. The policy of the CGT provisions is to assess the beneficiary who is 'presently entitled' to the capital gain (see the Explanatory Memorandum to the Bill which became the *Income Tax Assessment Amendment (Capital Gains) Act 1986*). Also, 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'. This Tax Office practice is also reflected in paragraph 4 of Taxation Determination TD 93/35.

29. In the absence of guidance from the courts, it is open to the Commissioner to take an approach which promotes the purpose of the relevant CGT provisions.

30. 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.

31. The Commissioner will, in the interests of practical administration, continue to apply the previous practice as modified in this practice statement.

32. Cases that raise related issues not specifically addressed by this practice statement should be escalated to the Losses and Capital Gains Tax Centre of Expertise for guidance. These include cases where the accounting gain made by the trust is less than the capital gain. Also included are situations where the accounting gain and the capital gain are made in different income years or where the capital beneficiary of the trust is a trustee of another trust.

Examples

Example 1: paragraph 2(a) case

33. The Glass Fixed Trust has three beneficiaries. Joanne is entitled to all the trust income. Charles and Jim each has a vested and indefeasible interest in 50% of the trust capital.

34. The trust makes a capital gain of $10,000 (which, it is assumed in this case, could not be reduced by the CGT discount). 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.

35. The net income of the trust estate 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.

36. The acceptable methods of taxing the 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 Charles and Jim – Charles and Jim each takes $5,000 of the trust capital gain into account in working out his net capital gain;

- with the agreement of only Charles (or only Jim) – Charles (or Jim) takes $5,000 of the trust capital gain into account in working out his net capital gain and Joanne takes $5,000 of the trust capital gain into account in working out her net capital gain;

- with the agreement of Joanne, Charles, Jim and the trustee – the trustee is assessed on the entire $10,000 net capital gain; or

- with the agreement of Charles (or Jim) – Charles (or Jim) takes $5,000 of the trust capital gain into account in working out his net capital gain and with the agreement of Joanne, Charles, Jim and the trustee – the trustee is assessed on $5,000 net capital gain.

Example 2: paragraph 2(a) case

37. The Plastic Family Trust is a discretionary trust.

38. The trust made a capital gain of $10,000 (which, it is assumed in this case, could not be reduced by the CGT discount) during the income year. The trust has no current year capital losses or prior year net capital losses. The trust also derived rental income of $5,000 during the income year.

39. The net income of the trust estate for the income year is $15,000 ($10,000 plus $5,000). The trust income for the same income year is $5,000. Bertrand is presently entitled to all of the income of the trust estate.

40. If Bertrand and the trustee do not agree otherwise, Bertrand will include the $5,000 directly in his assessable income and $10,000 in the calculation of his net capital gain.

41. Alternatively, they can agree that the trustee be assessed on the $10,000 capital gain. (Bertrand will be assessed on the remaining $5,000 of net income.)

42. As there is no beneficiary with a vested and indefeasible interest in the trust capital representing the trust's capital gain and no beneficiary has been allocated an amount of the capital gain, there is no possibility of the capital beneficiary approach applying. Further it is not necessary to obtain the agreement of any potential capital beneficiary in this case to a trustee assessment.

Example 3: paragraph 2(a) case

43. Take the facts in example 2 but change them so that during the income year the trustee advanced the capital gain to Bernice.

44. If Bernice agrees, she can include $10,000 in the calculation of her net capital gain. Alternatively, if Bertrand, Bernice and the trustee agree, the trustee can be assessed on the $10,000 capital gain. If there is no agreement to use either the capital beneficiary or the trustee approach, then Bertrand is assessed as per paragraph 40.

Example 4: paragraph 2(a) case

45. A capital gain is made by a testamentary trust. The trust has a life tenant who is presently entitled to trust income. The capital beneficiaries of the trust have contingent interests. In these circumstances, the proportionate approach or the trustee approach may be used. As the capital beneficiaries' interests are contingent, the capital beneficiary approach is not available. The trustee approach can only be used if the life tenant and the trustee agree in writing to use it.

Example 5: paragraph 2(b) case

46. The Autumn Trust has two beneficiaries. Amber is the capital beneficiary and Misty is the income beneficiary. The trust makes a capital gain of $10,000 (which, it is assumed in this case, could not be reduced by the CGT discount). Assume that the accounting gain made by the trust was $12,000. 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 did not derive any income during the income year.

47. The net income of the trust estate is $10,000. The trust income for the same income year is nil. As there is no trust income for the income year, no beneficiary can be presently entitled to it.

48. The net capital gain would ordinarily be assessed to the trustee under section 99 or 99A of the ITAA 1936. However Amber can agree instead to include the $10,000 capital gain in the calculation of her net capital gain.

49. Note 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. If the trustee were assessed under section 99A of the ITAA 1936 the benefit of the CGT discount would be reversed – that is, the trustee would be assessed on a $10,000 net capital gain. Alternatively if Amber agrees to include the trust's capital gain in the calculation of her net capital gain, she must gross up the trust capital gain to $10,000 and apply her own capital losses before applying the CGT discount.

Example 6: paragraph 2(a) and 2(b) cases

50. The net income of the Clear Family Discretionary Trust for an income year is $10,000 consisting of $2,000 interest income and $8,000 net capital gain (that was not reduced by the CGT discount or any capital losses). The trustee exercises their discretion to pay $1,200 of the trust income (that is, 60%) to Krystal. The trustee advances $2,000 of the trust capital gain to Fairlie.

51. As Krystal is presently entitled to 60% of the trust income, she would, under the proportionate approach, include 60% of the net capital gain ($4,800) in her income. This amount satisfies the requirements of paragraph 2(a) of this practice statement.

52. As there is no beneficiary presently entitled in respect of 40% of the trust income, the trustee would be assessed on the remaining 40% of the net capital gain ($3,200). This amount satisfies the requirements of paragraph 2(b) of this practice statement.

53. There are a number of alternatives if the capital beneficiary approach is chosen in respect of the $2,000 advance to the capital beneficiary (Fairlie). Those alternatives depend on whether the $2,000 for which the capital beneficiary approach is chosen is treated as reducing the paragraph 2(a) amount (that is, $4,800) or the paragraph 2(b) amount (that is, $3,200).

Option 1: treat advance as reducing the paragraph 2(a) amount

- Krystal includes 60% of the trust capital gain (that is, $4,800) in the calculation of her net capital gain.
- Alternatively:
  - Fairlie can agree to include $2,000 (of the $4,800) in the calculation of her net capital gain; and
  - Krystal be assessed on the remaining $2,800.
- Alternatively:
  - Fairlie can agree to include $2,000 (of the $4,800) in the calculation of her net capital gain; and
  - Krystal, Fairlie and the trustee can agree that the trustee be assessed on the remaining $2,800.
- Alternatively:
  - Krystal, Fairlie and the trustee can agree that the trustee be assessed on the whole of the $4,800.

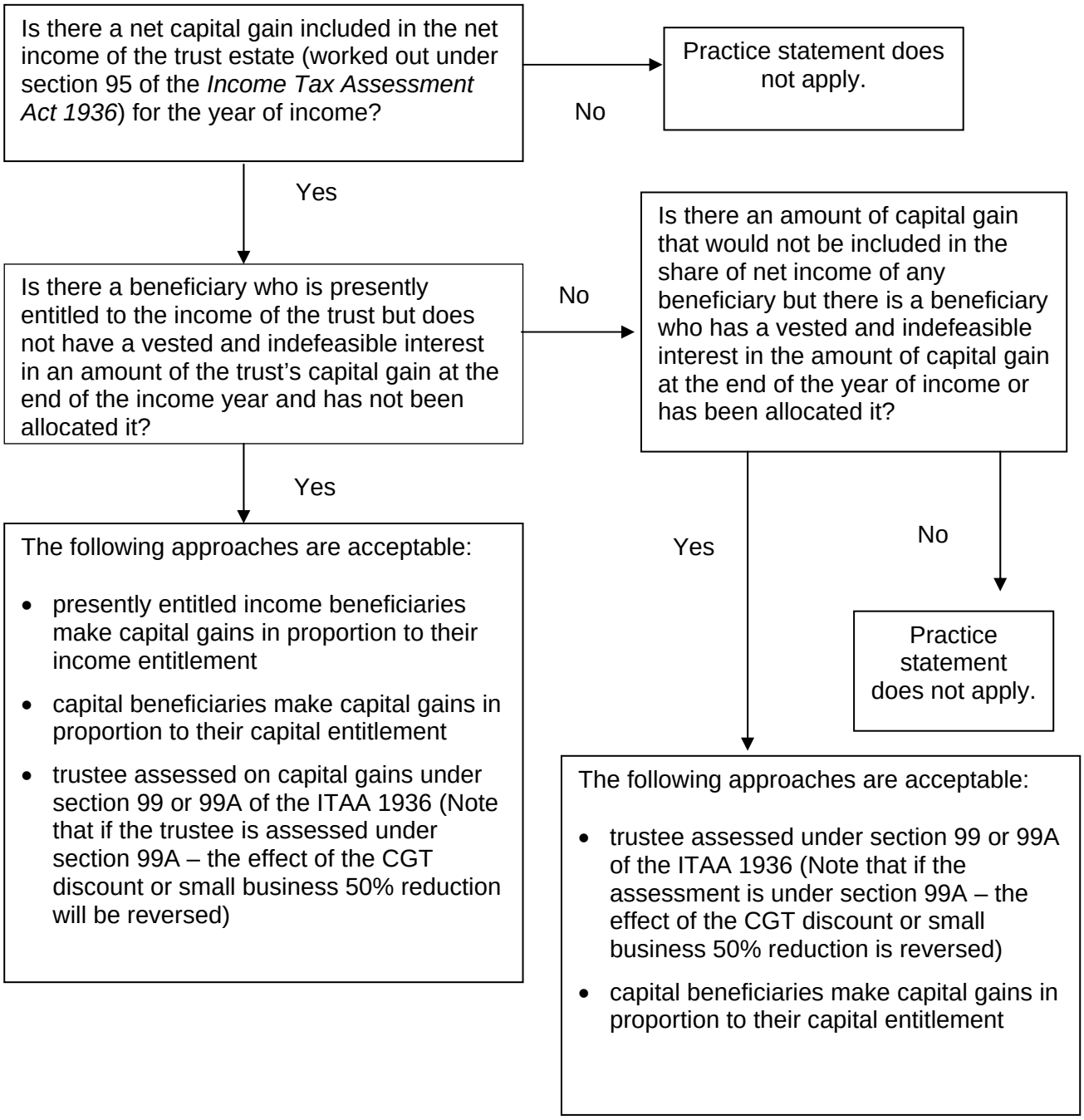
(Note: Regardless of which alternative is chosen under Option 1, the trustee is assessed on the paragraph 2(b) amount (that is, the remaining $3,200).)

Option 2: treat advance as reducing the paragraph 2(b) amount

- The trustee is assessed on the $3,200 amount.
- Alternatively:
  - Fairlie agrees to include $2,000 (of the $3,200) in the calculation of her net capital gain; and
  - the trustee is assessed on the remaining $1,200.

(Note: Regardless of which alternative is chosen under Option 2, the paragraph 2(a) amount (that is, the remaining $4,800) can be included in the calculation of Krystal's net capital gain, or the trustee can be assessed on it if Krystal and the trustee agree.)

Appendix: Flowchart summarising application of this practice statement.



Amendment history

Date of amendment	Part	Comment
30 June 2010	The practice statement	Annotated to limit application due to Bamford decision.
26 November 2007	References Contact details	Include issue date. Amend authorisation details. Updated.

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* subsection 97(1) *Income Tax Assessment Act 1936* paragraph 97(1)(a) *Income Tax Assessment Act 1936* section 98 *Income Tax Assessment Act 1936* subsection 98(4) *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* section 115-215 *Income Tax Assessment Act 1997* subsection 115-215(3) *Income Tax Assessment Act 1997* paragraph 115-215(3)(b) *Income Tax Assessment Act 1997* paragraph 115-215(3)(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
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