

Testamentary trusts and CGT

THE TAX LAWS CURRENTLY ASSESS BENEFICIARIES OF A TRUST WHO ARE PRESENTLY ENTITLED TO THE NET INCOME OF THE TRUST, TO THE NET CAPITAL GAINS DERIVED BY THE TRUST REGARDLESS OF WHETHER THE BENEFICIARIES ARE ENTITLED TO THE NET CAPITAL GAINS. THIS ARTICLE EXAMINES THE FEDERAL GOVERNMENT'S RECENT ANNOUNCEMENT, WHICH MAY HELP TO ADDRESS THIS ANOMALY IN THE CONTEXT OF TESTAMENTARY TRUSTS.



The current operation of the trust and capital gains tax (CGT) provisions in the *Income Tax Assessment Act 1936* ("ITAA 1936") and the *Income Tax Assessment Act 1997* ("ITAA 1997") has meant that the capital gains derived by a trust are taxed in the hands of the beneficiaries who are presently entitled to the net income of the trust, regardless of whether those beneficiaries are entitled to the corpus and the net capital gains themselves.

The Government recently issued a media release indicating that it intends amending the income tax legislation, to enable a trustee of a testamentary trust to choose to be assessed on some or all of the net capital gain derived by the trust in such situations.

This article discusses the manner in which testamentary trusts are presently subject to tax, and examines the impact of the proposed amendments.

THE PROPOSED AMENDMENTS TO THE CGT TREATMENT OF TESTAMENTARY TRUSTS

On 17 October 2006, the Minister for Revenue and Assistant Treasurer issued a media release entitled "Amendments to the Capital Gains Tax Treatment of Testamentary Trusts" ("the media release"), announcing that the Government will amend the income tax legislation that applies to testamentary trusts.

According to the media release¹:

"The amendments will allow the trustee of a testamentary trust to choose to be assessed on some part or all of an amount of net capital gain that is included in the net income of the trust where:

- That part or all of the net capital gain would be assessed to a presently entitled income beneficiary of the trust; and
- That beneficiary is not entitled under the terms of the trust to benefit from the gain."

The media release further states that the amendments will ensure that an income beneficiary is not assessed in respect of trust capital gains from which they will not benefit. It also states that allowing the trustee to make the choice on a beneficiary-by-beneficiary basis will ensure the trustee is not assessed on part of the capital gain in circumstances where no tax would have been paid on the gain by the income beneficiary; for instance where the income beneficiary is an exempt entity or foreign resident.

The legislation giving effect to this announcement is to be introduced as soon as practicable, following consultation with industry on the design and implementation of the amendments.

TAXATION OF DECEASED ESTATES

A testamentary trust is one that is created under a will. The will may direct the executor to make immediate distributions to beneficiaries after the granting of probate or it may establish a testamentary trust. For income tax purposes, the estate and the testamentary trust are treated as being one and the same².

A beneficiary of a deceased estate will be assessed in accordance with the general tax laws applicable to the taxation of trust income in Div 6 of Part III of the ITAA 1936. Whether a beneficiary is presently entitled to a share of the income of a trust estate will depend on the stage reached in the

administration of the deceased estate, the terms of the will, trust law principles, and whether any discretionary payments have been made to the beneficiary by the executor or trustee³. Generally, beneficiaries cannot enjoy a present entitlement to income derived by a deceased estate during the administration of the estate⁴ (unless the executors have actually paid some of the income to, or on behalf of the beneficiaries out of surplus funds⁵).

Therefore, where the administration of a deceased estate is completed during the course of an income year, the Australian Taxation Office will assess a presently entitled beneficiary under s 97 of the ITAA 1936 (provided the beneficiary is not under any legal disability)⁶. A beneficiary under a legal disability will be assessed under s 98 of the ITAA 1936.

THE NEED FOR LEGISLATIVE CHANGE

The proposed amendments appear to be aimed at addressing, specifically in the testamentary trust context, some of the problems that may arise for all trusts under s 97 of the ITAA 1936. These problems arise from the potential for significant differences between the accounting or trust income of a trust and its net income or taxable income for the purposes of the Act.

Broadly, s 97 provides that where a beneficiary is presently entitled to a share of the income of a trust estate and is not under a legal disability, the beneficiary is assessable on so much of that share of the net income as is attributable to a period when the beneficiary was:

- a resident of Australia, whatever the source of the income; and

- a non-resident, where the income is attributable to sources in Australia⁷.

Similarly, if the trust estate derives exempt income, or exempt or non-assessable non-exempt income, this income is also allocated amongst the beneficiaries in this manner⁸.

Section 95 of the ITAA 1936 defines “net income” in relation to a trust estate as the total assessable income of the trust estate calculated as if the trustee were a taxpayer in respect of that income and were a resident, less all allowable deductions. The definition thus encompasses receipts of a revenue and capital nature.

Where a trust has a net capital gain included in its net income for an income year, subDiv 115-C of the ITAA 1997 applies to ensure that the part of the net income that is attributable to the net capital gain is treated as a capital gain made by the beneficiary entitled to that part. This is to allow a beneficiary to apply any capital losses and the CGT discount against the grossed up amount of the capital gain.

The interaction of the trust provisions in the ITAA 1936 and the CGT provisions in the ITAA 1997 means that net capital gains are taxed in the hands of the beneficiaries who are presently entitled to the income of the trust in proportion to their relative entitlement to that income, irrespective of whether those beneficiaries are entitled to the net capital gain itself. This means that, where a trust has wholly distinct income and capital beneficiaries and has ordinary income and net capital gains in the same financial year, the income beneficiaries will be taxed on the whole of the net capital gain (as well as on the ordinary income) and the capital beneficiaries will not be taxed.

Up until now the manifest unfairness of this operation of s 97 has been addressed only in the form of practice statements from the Federal Commissioner of Taxation (“the Commissioner”). In particular, in Practice Statement Law Administration (PS LA) 2005/1, the Commissioner sets out acceptable approaches for the taxation of a net capital gain included in the net income of a resident trust estate for an income year. These approaches essentially allow either trustees or capital beneficiaries to be taxed on net capital gains, provided there is an agreement between the relevant parties.

“ The Government recently issued a media release indicating that it intends amending the income tax legislation, to enable a trustee of a testamentary trust to choose to be assessed on some or all of the net capital gain derived by the trust in such situations. ”

PS LA 2005/1 applies where:

1. an amount of a capital gain is included in the share of the net income of a beneficiary who does not have a vested and indefeasible interest in the amount of the capital gain at the end of the income year, and who has not been allocated it; or
2. there is an amount of capital gain which would not be included in the share of the net income of a beneficiary, but there is a beneficiary who has a vested and indefeasible interest in the amount of the capital gain.

In the first scenario, the Commissioner will accept the “proportionate”, “capital beneficiary” or “trustee” approach, and in the second scenario, the “trustee” or “capital beneficiary” approach⁹.

Under the “proportionate” approach, a beneficiary (or 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 income¹⁰.

Under the “capital beneficiary” approach, the capital gain may be assessed to a trustee on behalf of a beneficiary, or assessed to a beneficiary who has a vested and indefeasible interest in the trust capital or has been allocated the capital gain no later than two months following the end of the income year¹¹. 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 favour¹². In addition, a capital beneficiary must agree in writing, to the use of the capital beneficiary approach¹³.

Under the “trustee” approach, the trustee may be assessed on the capital gain under ss 99 or 99A of the ITAA 1936, regardless of whether the capital beneficiary approach would be met¹⁴. This approach can only be used if all income beneficiaries who are presently entitled to the trust income for the particular income year, capital beneficiaries who have a vested and indefeasible interest in the trust capital, and the trustee agree in writing to use it (so as to protect the trustee from claims by a beneficiary that the proportionate or capital beneficiary approach should have been adopted)¹⁵.

Whilst PS LA 2005/1 thereby provides an administrative “solution”, its status as an administrative practice statement means that it has no legal status and so there is always risk inherent in relying on it in any particular situation.

THE IMPACT OF THE PROPOSED AMENDMENTS

It is encouraging that the Government is attempting to remedy the problem legislatively, albeit in a limited way.

However, it is important to note the following:

Readjustment of the tax burden

The proposed amendments do not readjust the tax burden between beneficiaries of trusts. Rather, they readjust the tax burden between an income beneficiary and the trustee of the trust.

Trustee’s choice

The announcement indicates that the amendments allow the trustee a choice to include the net capital gain in its income in any particular situation.

The effect of this appears to be that a trustee of the testamentary trust will be able to decide which course of action to adopt according to which gives the best tax result. This appears to be borne out by later comments in the media release that¹⁶:

“Allowing the trustee to make the choice on a beneficiary-by-beneficiary basis will ensure the trustee is not assessed on part of the capital gain in circumstances where no tax would have been paid on the gain by the income beneficiary, for instance where the income beneficiary is an exempt entity or a foreign resident”.

Type of testamentary trust

It is not clear from the media release whether the proposed amendments will be wide enough to cover “standard” type discretionary testamentary trusts or whether they will be limited to testamentary trusts that have distinct and different income and capital beneficiaries.

The media release does contain the statement “the amendments will improve the taxation treatment of income beneficiaries in testamentary trusts, such as life tenants”, which tends to suggest that the latter, more limited application may apply. This conclusion is also supported by the fact that the media release only refers to the trustee being assessed on the net capital gain rather than allowing any assessments to a beneficiary who might be presently entitled to the capital gain. It may therefore be that the legislative amendment goes no further than the specific example 4 in PS LA 2005/1, which deals with a life tenant example (reproduced below):

Example 4¹⁷:

“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”.

Operative date

Because according to the media release, “the amendments will apply to the 2005-06 and later income years”, those who have recently made or are contemplating making distributions of income or capital from testamentary trusts would be well advised to defer any further action until the content of the proposed legislative amendments is known.

Although the media release states that legislation “will be introduced as soon as practicable”, there is an allowance for consultation. It is hoped that this consultation process will be swift and productive so that the legislation may be in place in plenty of time for appropriate action to be taken.

It would be even better if this consultation process could lead to the “holy grail” of a complete legislative solution to the s 97 problem. We will just have to wait and see.

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Reference notes

- 1 Refer <http://assistant.treasurer.gov.au/pcd/content/pressreleases/2006/074.asp?pf=1>
- 2 Refer IT 2622, para 5
- 3 Refer IT 2622, para 7
- 4 Refer IT 2622, paras 9 and 10
- 5 Refer IT 2622, para 14
- 6 Refer IT 2622, para 17
- 7 Section 97(1) of the ITAA 1936
- 8 Section 97(2) and (3) of the ITAA 1936
- 9 Refer PS LA 2005/1, paras 4 and 11
- 10 Refer PS LA 2005/1, paras 5 to 7
- 11 Refer PS LA 2005/1, paras 8 and 9
- 12 Refer PS LA 2005/1, para 10
- 13 Refer PS LA 2005/1, para 14
- 14 Refer PS LA 2005/1, para 10
- 15 Refer PS LA 2005/1, para 15
- 16 Refer <http://assistant.treasurer.gov.au/pcd/content/pressreleases/2006/074.asp?pf=1>
- 17 Refer PS LA 2005/1, para 45

