Chapter 22

BRINGING TRUSTS INTO THE NEW ENTITY REGIME

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Key policy issues

What trusts should be excluded from the new entity tax system?

General principle

22.1 The proposed new entity tax system would apply to all resident trusts unless they are specifically excluded. The extended definition of 'trustee' contained in the current tax legislation would not be used for determining which trusts would be covered by the new entity tax system. Rather, the term 'trust' would assume its ordinary meaning so that arrangements that come within the equitable concept of a trust relationship would be taxed as entities unless specifically excluded.

22.2 *A New Tax System* indicated that consultation would be undertaken on which trusts could be excluded from the new entity tax system. The general principle for exclusion proposed in *A New Tax System* is that trusts which have been created or settled only as a legal requirement or subject to a legal test or sanction could be excluded. This principle is aimed at those trusts where the beneficiary (and the settlor or parent or guardian) would not usually have any real say in the use of a trust structure. This principle distinguishes such trusts from trusts created at a settlor's direction. Appendix A lists those trusts that could be excluded from the new entity tax system on the basis of the general principle.

22.3 Some other types of trusts may also be excluded from the entity regime. These types of trusts include the following:

- trusts where the trustee holds property on trust, with no interest in or duty as to the trust property other than to hold that property for the absolute benefit of specified beneficial owners — that is, the beneficiaries are 'absolutely entitled' to the trust property; and
- constructive trusts (many of which would be excluded by the general principle set out above).

Taxation treatment of 'excluded trusts'

22.4 One option would be to apply a modified Division 6. That Division currently specifies the rules for the taxation of most trusts. The modifications to Division 6 would reflect the nature of excluded trusts, including the limited potential for such trusts to be used for commercial activities, and for interests in such trusts to be sold. Beneficiaries would be assessed on the basis of their present entitlement to a share of the income of the trust.

22.5 If trust law and taxation law treat capital gains differently the potential exists for beneficiaries to be taxed on amounts to which they are not entitled under trust law. For example, if capital gains are included in 'income' for tax purposes, 'income only' beneficiaries could be assessed on capital gain that they have no right to receive under trust law. The modified Division 6 could address this by having separate, but parallel provisions, dealing with a beneficiary's entitlement to the income and capital of the trust. Such parallel provisions would ensure that 'income' and 'capital' beneficiaries under trust law only have a tax liability for amounts in which they have a beneficial interest.

Treatment of trusts for an 'absolutely entitled' beneficiary

General principle

22.6 With some trusts the trustee merely holds property on trust, with no interest in or active duty as to the management of the trust property other than to hold that property for the absolute benefit of specified beneficiaries. A distinguishing feature of this type of trust is that the absolute entitlement to the property exists from the outset of the trust, and may be held either by a single beneficiary or by beneficiaries jointly. This type of trust can involve assets in a wide range of circumstances including the following:

- each parcel of shares purchased by a stockbroker may give rise to this type of trust — a stockbroker could have hundreds of these trusts at any one time, which may last for periods from a few hours to days to weeks;
- property held through trust accounts maintained by some professions (such as lawyers, accountants and real estate agents where each transaction may give rise to trusts of this type); and
- certain types of bank accounts for children.

22.7 The type of trust would also cover trusts where minors have an absolute entitlement to property even though they may not be able to give a valid discharge or to call for the property to be transferred to them. Generally, however, trusts for minors are not of this type as the minor will not be absolutely entitled to the trust property from the beginning of the trust.

22.8 Beneficiaries who are absolutely entitled to the income and capital of the trust from its inception are the beneficial owners and have the real economic ownership of the entire property of the trust. Consequently, one approach would be to ignore the trust relationship and treat the acts of the trustee as those of the beneficiary or beneficiaries, where those beneficiaries are absolutely entitled to the income and capital from the creation of the trust.

Beneficiaries of such a trust, for tax purposes, would have no separate interest in the trust, as they would be treated as owning the property directly.

22.9 This treatment would not extend to the situation of a beneficiary becoming absolutely entitled during the life of the trust. Trusts where there is no absolute entitlement from the outset of the trust would be subject to entity tax. If an absolute entitlement subsequently came into existence, that entitlement would not alter the status of the trust, but could result in a partial or full extinguishment of the beneficiary's interest in the trust. Possible rules for partial or full extinguishment are set out in Chapter 19.

22.10 As noted, arguably, where minors have an absolute entitlement to trust property they may not be the economic owners of the property. They cannot call for the property or direct its application. This is a fine legal distinction that could, in the absence of specific treatment result in many bank accounts of minors being treated as entities. It would be necessary to specifically treat this type of trust as not falling within the entity tax regime.

Treatment of stakeholders

22.11 A stakeholder is an independent party who holds money, or other property, until a specified event (the crystallising event) occurs. On the occurrence of the crystallising event the stakeholder has an obligation to transfer the money or property in accordance with specific directions determined by the outcome of the crystallising event. For example, a stakeholder would be the person who:

- holds the stakes of the parties to a wager, and has an obligation to pay the winning party the specified amount; or
- holds deposits prior to the completion of the sale of land.

22.12 Some stakeholder arrangements may amount to a trust under the law of equity. Stakeholders, or similar arrangements that are trusts, cannot be treated in the same way as those trusts discussed above with 'absolutely entitled' beneficiaries. The option discussed above cannot be applied as it is impossible, prior to the crystallising event, to identify a beneficiary who is absolutely entitled to the trust property. This is the case even though once the crystallising event has occurred the relevant beneficiary may be treated as having always been absolutely entitled to the property.

22.13 One approach would be to treat any trust arising from such a stakeholder relationship as an entity for tax purposes. Such a trust would continue to be subject to the entity tax regime until all the beneficial interests in the trust property have been extinguished. Consequently, the creation of an absolute entitlement, on the occurrence of the crystallising event, would not change the status of the trust.

22.14 This approach would mean that transactions such as holding stakes in a wager, holding deposits prior to the completion of the sale of land, or the paying of money into court prior to the determination of the merits of a particular case, could give rise to entity taxation. This would increase compliance and administration costs, for example, relating to the preparation and processing of individual taxation returns for each stakeholder arrangement. Consideration needs to be given to methods of reducing compliance and administration costs for stakeholder arrangements. One option would be to only impose entity taxation if the stakeholder arrangement is to extend, or is reasonably likely to extend, beyond a specified period of time, such as, six months.

Treatment of constructive trusts

Key considerations

22.15 A constructive trust is a means whereby the law of equity imposes a liability upon a person to account for certain property as if that person was a trustee.

22.16 Constructive trusts have been imposed in a wide variety of situations, such as where a person has made an unauthorised gain in a situation of actual or potential conflict of interest.

22.17 Once recognised by a court, the trust is viewed as having existed from the date of the original breach or other action (or inaction) that gave rise to the finding of a constructive trust. Thus a trust can exist even though neither the trustee nor the beneficiary was aware of its existence.

Example 22.1: Creation of a constructive trust

Robert is an employee of XYZ Ltd, and owes a fiduciary duty to the company. In breach of that duty Robert makes a gain of $100 on 1 July 2000. The gain is income under ordinary concepts. He invests that money at 10 per cent. He incurs transaction costs of $1 per year on that investment. On 1 July 2002 a court finds that Robert was in breach of his fiduciary duty and that a constructive trust existed from 1 July 2000. Robert repays to XYZ Ltd $120 (being the original gain plus interest) on 1 July 2002.

Robert is the trustee of the constructive trust, and XYZ Ltd is the beneficiary.

22.18 The principle for exclusion from the entity tax regime stated in *A New Tax System* would cover constructive trusts that come into existence by

operation of law rather than by the choice of a settlor. However, applying the modified Division 6 to constructive trusts would not be appropriate given that they may exist without the knowledge of the trustee or beneficiary. Nor would it be appropriate, for practical reasons, to treat the actions of the trustee (as Robert would be), prior to a court recognising the existence of the trust, as those of a beneficiary.

22.19 The correct treatment would require that income tax assessments made prior to court recognition be amended to reflect that later recognition. For example, the income tax assessments of the trustee for the years prior to recognition would need to be reversed, while the beneficiary's assessments would need to include the income that was removed from the trustee's assessments. In many cases, the period for making amendments may have expired.

Option: 'Look through' to the trustee

22.20 The constructive trust, and any interest in such a trust, could be ignored for taxation purposes. Income derived from the investment or use of the trust property would be treated as having been derived, beneficially, by the person who is the constructive trustee, and not by the trust. The amount would be included in the trustee's personal assessable income in the year it is derived. Deductions incurred by the trustee in earning that income, prior to the court formally recognising the existence of the trust, would be allowable personally to the trustee in the year in which they were incurred.

22.21 Assets held, and income derived, by the constructive trust after the court formally recognises the existence of the trust would be treated as being held, or derived, by the beneficiary directly.

Example 22.2: Treatment of constructive trust under this option

This continues the example started above.

In the 2000-1 income year $100 (the gain derived as a result of the breach of duty) is included in Robert 's assessable income. In each of the 2000-01 and 2001-02 income years $10 (the interest earned on investing the $100) is included in Robert's assessable income. Robert is entitled to a deduction of $1 for the costs of earning that income.

In the 2002-3 income year $120 is included in the assessable income of XYZ Ltd. That amount represents the original gain plus interest paid to XYZ Ltd by Robert. XYZ Ltd is entitled to $2 of deductions representing the cost to Robert of earning that income.

In the 2002-3 income year $2 is included in Robert's assessable income, representing the deductions previously allowed to Robert for the costs in earning the repaid income. Robert is entitled to a deduction of $120 in the year representing the repaid income that was included in his assessable income.

What should be the taxation treatment of trust distributions to minors?

Current treatment

22.22 Division 6AA of the 1936 Act generally applies to all dependent children if they are less than 18 years old on the last day of an income year. It does not apply to working children, or children with special needs.

22.23 The general effect of the rules is that unearned taxable income of dependent children, above a specified level ($416), is assessed using the higher rates of tax set out in the *Income Tax Rates Act 1986*. The higher rates of tax can apply both to a minor who is a beneficiary of a trust estate and to a trustee of a trust estate in which a minor is a beneficiary and in respect of whom the trustee is liable to be assessed to pay tax.

22.24 If the Division applies to a particular minor, the higher rates provided in the *Income Tax Rates Act 1986* would usually apply only to that part of the minor's assessable income that is not from employment or a business carried on by the minor. The amount to which the Division applies can be reduced further by certain allowable deductions. The higher rates do not apply to income from the investment of certain money or property such as that transferred to the child in certain circumstances (excluded income). Also

income from property held on trust for a minor in specifically defined circumstances will not be subject to Division 6AA.

Application of Division 6AA to excluded trusts and trusts taxed under the new entity tax system

22.25 Division 6AA would generally apply to all trust distributions made to a minor, even distributions by 'excluded trusts' that are taxed under a modified Division 6. However, the current exclusions from the operation of Division 6AA would also continue. Because the list of possible excluded trusts in Appendix A to this chapter includes almost all of the trusts that are currently exempt from Division 6AA, in practice Division 6AA would likely only rarely apply to trusts which are to be taxed under the modified Division 6.

22.26 Distributions from trusts that are not 'excluded trusts' would be subject to the entity regime (including the deferred company tax or resident dividend withholding tax), with child beneficiaries being taxed at the rates set out in Division 6AA.

Treatment of child maintenance trusts

22.27 Child maintenance trusts are often formed as a result of a family breakdown. They are usually set up by a parent for the purpose of paying amounts in the form of maintenance for the children of the parent.

22.28 Under the current law, Division 6AA does not apply to the income from the transfer of property to a minor or to a trustee for the minor's benefit, provided detailed criteria set out in the law are met.

22.29 Upon the introduction of the new entity tax regime, child maintenance trusts could be subject to the entity tax regime on the basis that they do not meet the general principle of exclusion. Distributions by the trust could be fully franked distributions under the regime. With the availability of refunds for excess imputation credits and the maintenance of the current criteria for excluding these trusts from Division 6AA, the tax outcome would be little changed under the new regime.

22.30 For those trusts that meet the criteria for exclusion from Division 6AA, the refund of excess imputation credits available to individuals would mean that minor beneficiaries would pay tax at the ordinary marginal tax rates. Distributions by a trust that do not meet the current criteria for exclusion would continue to be taxed in accordance with Division 6AA. In this latter situation the trustee would be required to deduct from the actual distribution an amount sufficient, when added to any franking credit attached to the distribution, to meet the beneficiary's liability under Division 6AA.

How should some specific trust issues be addressed?

Trusts that have multiple purposes

22.31 A trust may hold property for a number of purposes. The simple fact that a trust holds property for purposes, some of which would come within one or other of the exclusions discussed above, does not mean that the trust as a whole would not be subject to the entity tax regime.

22.32 One option for dealing with this situation would be to split the trust, for taxation purposes, into two or more separate trusts. Property that is held on trust solely for a purpose that falls within one of the exclusions would be treated as being the subject of a separate trust. All of the other property would be treated as being held by a single trust for non-excluded purposes.

Distinguishing discretionary and hybrid trusts from fixed trusts

22.33 The nature of discretionary and hybrid trusts differs markedly from fixed trusts and companies. Consequently, full alignment of the tax treatment for these entities does not appear possible. For example, the continuity of ownership test applicable to fixed trusts would not be appropriate for a discretionary trust as the objects of a discretionary trust generally do not have an interest in the trust property.

22.34 Given that the rules for discretionary trusts and hybrid trusts would need to differ in some circumstances, fixed trusts and non-fixed trusts (which include both discretionary and hybrid trusts) would need to be defined. The current trust loss measures define a trust to be a fixed trust if there are persons who have fixed entitlements to all of the income and capital of the trust. A trust is a non-fixed trust if it is not a fixed trust. One option would be to adopt these definitions for the new entity tax system.

Restructuring of trusts

22.35 Trust deeds may be altered to make them more compatible with the new entity tax regime. Such alterations would not generally result in a resettlement for taxation purposes, provided the changes do not go beyond what is necessary to make the trust compatible with the new regime.

22.36 Consideration needs to be given to the taxation treatment of the types of costs associated with making trust deeds compatible with the new entity tax regime, for example, legal costs and stamp duty costs.

Subsequent settlements on existing trusts

22.37 A subsequent settlement on an existing trust can be viewed either as an addition to the existing trust or the creation of a new trust.

22.38 Under the proposed entity tax regime one option would be to have a rebuttable presumption that subsequent settlements are intended to be additions to the existing trust, rather than the creation of a new trust. The presumption would be rebutted by evidence that the settlor expressly intended that a new trust be created.

How should an entitlement to unpaid income or capital of a trust be treated?

22.39 A beneficiary may have a present entitlement to the income or capital of a trust, yet the trustee retains within the trust estate the money or property which represents that income or capital. This money or property is held for the benefit of the beneficiary with the present entitlement. In many cases the money or property is retained under an express power. Under trust law the legal status of this retained money or property is unclear. Under one interpretation of the law it remains part of the existing trust estate. Under another interpretation the retained money or property is held under a separate trust.

22.40 Since each trust (other than excluded trusts) is a taxable entity, under the new entity tax system, the second interpretation would result in each of the separate trusts being treated as a separate taxable entity. This could generate high compliance costs for trustees. There are two options for dealing with this.

Option 1: Rebuttable presumption

22.41 An option for dealing with this issue would be to have a rebuttable presumption that the money or property that represents the unpaid distribution would remain an asset of the original trust. There would be only one trust for tax purposes.

22.42 The presumption would be rebuttable in those cases where there is an express agreement between the trustee and the relevant beneficiary that the unpaid distribution is to be held by the trustee in a separate trust. In the latter situation, the separate trust would be subject to the entity tax regime. In such a case the unpaid amount would be both a distribution to the beneficiary and the contributed capital of the separate trust.

Option 2: Distribution and loan back

22.43 A second option would be to treat the creation of the present entitlement as a distribution to the beneficiary with that entitlement. The amount retained by the trustee would be treated as a loan by the beneficiary to the trust. Any payment of that amount to the beneficiary would be treated as a repayment of the loan, not a distribution.

22.44 This option is inconsistent with the uniform distribution regime for entities discussed in Chapter 18. The option essentially retains the current present entitlement basis of assessing trust beneficiaries.

When should a trust be treated as having been created or wound up for taxation purposes?

22.45 A trust would be treated as having come into existence when the law of equity first recognises the existence of a trust relationship. A trust taxed as an entity under the new tax system would be treated as coming to an end when the trust ceases to exist. For example when:

- the trustee terminates the trust;
- the assets of a trust are distributed in accordance with a court order;
- both the legal and beneficial ownership of the trust property becomes vested in one person; or
- there is a resettlement of the trust.

Reforming the taxation treatment of trust resettlements

22.46 A resettlement results in the creation of a new trust for the purposes of both the general law and taxation. The creation of such a new trust can result in a taxation liability. However, neither trust law nor taxation law is clear as to what constitutes a resettlement. Consequently, it is unclear when, or if, such a taxation liability comes into existence.

22.47 Under trust law, where there is a resettlement, a new trust has been created in respect of some or all of the property that was the subject of the original trust. The original trust may either cease to exist or continue in respect of property that was not the subject of the resettlement. A resettlement of a trust may occur as a result of changes to a trust deed, changes to the substance or nature of a beneficiary's interest in the trust or changes to the operations of a trust. A change in the trustee, that does not result in a substantial alteration

in the interests of existing or potential beneficiaries or discretionary objects, would not generally amount to a resettlement.

22.48 Under the current tax law, a resettlement may have a number of tax consequences for the trustee in relation to things such as capital gains tax (CGT), revenue and capital losses, foreign tax credits, depreciation balancing adjustments and trading stock. It may also have implications for beneficiaries.

22.49 If there is a resettlement of a trust, the assets of the old trust, for example, would be deemed to be disposed of by the trustee at their market value for the purposes of the current CGT provisions (rollover relief may be available in limited circumstances). The trustee of the new trust would acquire the assets of the old trust at the time of the resettlement for the market value of the assets. It would follow that pre-CGT assets of the old trust would become post-CGT assets of the new trust and post-CGT assets of the old trust would generate a taxable capital gain or capital loss at the time of resettlement. The beneficiaries would be treated as having disposed of their interest in the old trust, and may, depending on the circumstances, be treated as having acquired an interest in the new trust.

22.50 The introduction of a consistent entity tax system provides an opportunity to establish clearly when a resettlement occurs and the consequences of that resettlement for taxation purposes.

Option 1: Define the concept of 'resettlement' for tax purposes

22.51 The general principle would be that a resettlement occurs when there has been a substantial alteration in the interest of existing or potential beneficiaries or discretionary objects. The rules would need to distinguish a resettlement from the situation where there is a partial vesting of a trust. Partial vesting is discussed in Chapter 19. Circumstances which could be taken into account in developing statutory tests for resettlements are explained by the following questions.

- Have new beneficial interests in the trust property been created, and are those new interests substantial? This might occur because the trustee acquires a beneficial interest, or because a new class of beneficiaries is introduced.
- Have existing rights or beneficial interests been varied in a manner that changes the substance or nature of the interests?
- Have there been any changes in the purpose for which the property is held?
- Has a new charter of future rights and obligations been created?

- Has a new or different relationship been established (bearing in mind that a trust is the relationship or circumstance in which a trustee holds property for another person or purpose)?
  - An indication that a new or different relationship has been established may be if a new person (a beneficiary) or a new purpose is introduced.
  - Another indication may be if a varied regime of interests is provided for, different in substance from that which previously existed.
- Has additional property been settled on the trust that results in the creation of a second trust, even if that trust is on the same terms as the first trust?

22.52 The statutory resettlement rules could potentially apply in a wide range of situations, including the following:

- an arrangement which involves the takeover or merger of two or more trusts;
- changes or additions to the beneficiaries or classes of beneficiaries in trusts (for example, to include spouses, new employees, or related companies or trusts); and
- an exercise by the trustee of a power of advancement or appointment.

22.53 Under this option when a trust is resettled and there is a new entity for tax purposes, the 'old' entity would be treated as having disposed of all of its assets to the new entity. This could mean that the 'old' entity would realise any gains on pre-CGT assets, inflationary gains on post-CGT assets and gains subject to the 50 per cent goodwill exemption. The market value of all the trust assets would generally be credited to the new entity's contributed capital account.

Option 2: Ignore resettlement and apply value shifting rules

22.54 Under this option a resettlement of a trust would be ignored for taxation purposes. Instead, any alteration in the proportional interest of beneficiaries in the trust as a result of the resettlement would be:

- made subject to the value shifting rules discussed in Chapter 29; and
- taken into account for the purposes of the continuity of ownership test for losses and bad debts.

22.55 It would be necessary to draw a clear distinction between this situation and the vesting (termination) of an existing trust and the creation of a new trust. For example, a resettlement could be defined to occur if there has been a greater than 50 per cent change in the income and capital interest of the members of the trust. This would result in a termination of the existing trust and the creation of a new trust. The value shifting rules would apply where there has been less than a 50 per cent change in the income and capital interest of the members of the trust. This result would be consistent with the result achieved by the option to remove the same business test discussed in Chapter 28.

Discussion of the options

22.56 The value shifting option is likely to be simpler to implement than the resettlement option. That option is also closer in operation to both the current treatment of companies and the proposed options for company treatment in the future. However, some situations relating particularly to discretionary trusts would be better covered by resettlement rules. For example, the addition of new objects to a discretionary trust, particularly when accompanied by a change in the effective control of the trust, could be a resettlement. It is unlikely that the value shifting rules would apply in this situation, as the objects of discretionary trusts do not have an interest in the trust's property. Consequently there has been no shift in value from one member to another. Under this approach the change in control is ultimately dealt with under the distribution rules when that control leads to actual distributions. However, such distributions may only occur when the trust is fully vested. In effect there would be a delay in the taxing point compared with a resettlement approach which could result in a tax liability at the time of the resettlement. This may not be an unreasonable result, as it is only on the receipt of the distribution that the discretionary object can access the value that has been shifted.

22.57 Option 1 is likely to be more complicated, as it would require both criteria for identifying and dealing with resettlements plus rules setting out the interaction between the resettlement and value shifting rules. In addition, it is not certain that any set of resettlement rules would deal effectively with all changes in control of discretionary trusts. Moreover, in some situations a resettlement may occur where there has been a less than 50 per cent change in the income and capital interest of the members. Option 1 in such a situation effectively would deny all carry-forward losses.

How should distributions from trusts attract the benefit of certain primary producer arrangements?

22.58 *A New Tax System* proposes that income distributed from existing and future trusts would continue to attract the primary producer averaging provisions and the farm management deposit arrangements.

Primary producer income averaging

22.59 Primary producer income averaging provides a means of addressing the effect of the progressive tax rate schedule on the tax liability of primary producers caused by their relatively variable incomes. They may have a higher average tax liability over a period of time than other income earners with more stable incomes, even where total income over the period is the same.

22.60 An eligible primary producer is able to average income from primary production over a period of up to five years. Primary production income earned by a trust retains its character when assessed to a beneficiary and (with some limitations) the beneficiary is deemed to be an eligible primary producer. This is not the case with primary production income earned by a company. Such income loses its character when distributed and currently does not attract the averaging provisions.

22.61 Under the new entity tax system, income distributed by a trust would no longer retain its original character unless expressly provided for.

22.62 An option to deal with this would be to provide the following treatment.

- Upon distribution, income eligible for primary producer averaging would retain its character as primary production income in the hands of the beneficiary.
- Under either of the options for full franking in Chapter 15, the income for the purposes of the averaging calculation would be the grossed-up amount of the actual distribution (reflecting the fact that the distribution would be franked). The grossed-up amount would also be used to determine whether the averaging provisions are available to primary producers who are not currently averaging their income.
  - The full amount of (refundable) franking credits would be available in that year.
- It would be necessary for trustees to maintain adequate accounting records to determine what is a distribution of primary production income, and provide that information to beneficiaries as required.

Farm management deposits

22.63 Farm management deposits (FMDs) are a means through which primary producers may reduce fluctuations in their income by depositing income into FMDs in good years and removing it in bad years. The amount deposited into the scheme by the taxpayer is deductible and withdrawals are assessable.

22.64 A presently entitled beneficiary of a trust may only claim a deduction for the portion of taxable primary production income that is distributed to them. The sum of the deductions made by presently entitled beneficiaries of a trust must not exceed the taxable primary production income of the trust in that income year.

22.65 Deposits are normally made by the taxpayer. In the case of trusts this is generally the presently entitled beneficiary. Where a presently entitled beneficiary is under a legal disability, the trustee may make the deposit on behalf of the beneficiary. A trust cannot itself claim deductions for FMD deposits.

22.66 To allow trust beneficiaries to continue to have access to FMDs, only minor amendments would need to be made to the FMD provisions. Consistent with primary producer income averaging, primary production income would retain its character when distributed so that the beneficiary could then deposit income into a FMD.

22.67 For a presently entitled beneficiary under a legal disability, trustees could continue to deposit amounts into an FMD on a beneficiary's behalf. However, such a deposit would itself be a distribution under the entity system.

What issues arise with cost bases of beneficial interests in trusts?

22.68 The proposed entity tax regime provides an opportunity to clarify the operation of those CGT provisions that continue to apply to trustees and beneficiaries.

Property transferred to a beneficiary (in-kind distributions)

22.69 An in-kind distribution from a trust to a beneficiary should be treated in the same way as an in-kind distribution by a company to a shareholder. Where an asset is transferred to the beneficiary (in their capacity as a beneficiary), the trustee would be treated as having realised the asset. For post-CGT assets, the trustee would be required to include the net capital

gain in assessable income, or determine the amount of net capital loss available to be carried forward. Under the entity tax regime, the net capital gain (subject to any reduction by revenue losses or other allowable deductions) would be subject to tax at the general rate of tax applicable to entities.

22.70 Under the entity tax regime the beneficiary would generally be treated as having acquired the asset for its market value at the date of the transfer. On actual disposal of the asset, the beneficiary would be subject to tax only on the capital gains arising after the asset is transferred.

22.71 The market value of the asset would be a distribution to the beneficiary and subject to the profits first rule to determine the assessable amount. However, if the distribution represents a full or partial extinguishment of the beneficiary's interest in the trust then the slice approach set out in Chapter 19 would apply in determining how much of the market value of the asset is treated as contributed capital and how much is profit.

Disposal of beneficial interests in trusts to third parties

22.72 The disposal of an interest in a trust by a beneficiary to a third party would be a realisation of the interest for taxation purposes.

22.73 Under the proposed entity tax regime the intention would be to treat an interest in a trust in the same way as a share in a company. Consequently, a beneficiary's interest in a trust would be treated as if it were a separate asset comprising all of the beneficiary's equitable rights in the assets of the trust, together with any equitable rights against the trustee (such as, rights arising from improper administration of the trust).

Where a beneficiary has a cost base

22.74 The suggested rules for determining the cost base for the interest in the trust are as follows:

- Where a beneficiary acquires an interest in the trust before the implementation of the new entity tax system and the taxpayer already has a cost base for the interest, the taxpayer would continue to use this cost base.
- Where a beneficiary acquires an interest in the trust after the start of the entity tax regime; and
  - the interest is purchased by the beneficiary, as part of an arm's length transaction, the beneficiary's cost base would be the purchase price of the interest;
  - the interest is assigned to the beneficiary for value as part of an arm's length transaction, the cost base would be the market value of the assignment; or

  - the interest is created or acquired as part of a non-arm's length transaction and the previous beneficiary was assessed on the basis of the market value of the asset when it was disposed of, the new beneficiary's cost base for the interest would be the market value used in assessing the previous beneficiary.

- If the person is an object for the possible exercise of a discretion to distribute the income or capital of a trust, there is no cost base in respect of any interest in the trust which arises from their capacity as an object for the exercise of the discretion. Such an object does not have a vested and indefeasible interest in the capital of the trust. This rule would cover both the objects of a discretionary trust and the objects of any discretion as to distributions exercised by the trustee of a hybrid trust.

- In those cases not covered by the above rules, the cost base would be specified according to the relevant circumstances; for example the specification of the cost base of an asset held by the legal personal representative of a deceased person.

- In all other cases the cost base would be zero.

22.75 The practical effect of these arrangements would be that when a beneficiary disposes of an interest in the trust, the beneficiary would be assessed on the capital gain received. This would essentially be the difference between the amount received and the beneficiary's cost of acquiring the interest.

Where a beneficiary does not have a cost base

22.76 As a result of having a zero cost base under the rules set out above beneficiaries could be taxed, under the proposed new entity tax regime, on distributions of contributed capital. Normally such distribution would not be assessable to the beneficiary, and simply result in a reduction in the cost base of the beneficiary's interest in the trust. If the contributed capital distribution exceeds the cost base, then the excess would be included in the beneficiary's assessable income. However, in these cases the beneficiary does not have a cost base. Consequently, the full amount of every distribution of contributed capital would be included in the beneficiary's assessable income. In the case of a discretionary trust, this would mean every dollar of contributed capital would be assessed when distributed.

22.77 For fixed trusts one option to avoid this where there is a full or partial extinguishment of a beneficiary's interest in the trust would be for the beneficiary to receive a cost base in respect of the interest extinguished. That cost base could equal the contributed capital component of the distribution from the trust made as a consequence of that extinguishment. The

circumstances in which there would be a contributed capital component are discussed in Chapter 19.

22.78 If the beneficiary disposes of all or part of the interest (if any) in the contributed capital of the trust to a third party, the cost base would be set by reference to the disposed interest in the contributed capital of the trust. Again, the objects of a discretionary trust would not have a cost base as they do not have a vested and indefeasible interest in the capital of the trust.

22.79 These rules would not apply where, but for the operation of cost base reduction rules similar to the current CGT cost base reduction rules, the beneficiary would have had a cost base. For example, if the beneficiary originally had a cost base, but that base has been reduced to zero due to receipt, in the past, of distributions of contributed capital, there would be a zero cost base under these rules.

What issues arise with deceased estates and testamentary trusts?

22.80 Some issues arising with the existing law relating to deceased estates and testamentary trusts could be addressed as part of the move to the proposed new entity tax system. They are as follows:

- the appropriate method of taxing disposals of 'life' and 'remainder' interests in property and the associated allocation of cost bases between such interests;
- the appropriate method of treating the transfer of an asset from a legal personal representative (LPR) either to a natural beneficiary or to a beneficiary which is not a natural person, including the appropriate cost base to be attributed to the various parties upon transfer; and
- the appropriate method of treating the transfer of an asset — including a principal residence — from a testamentary trust to a beneficiary, including the relevant cost base to be allocated to the testamentary trust's contributed capital and to the beneficiary upon transfer.

Treatment of disposals of interests by 'life tenants' and 'remaindermen'

22.81 The terms 'life tenant' and 'remainderman' are used to describe particular entitlements to income and capital of a trust. The life tenant is usually entitled to the income or the benefit of property held by a trust estate for the term of that person's, or some other person's, life. The remainderman

is beneficially entitled to the income and capital of the trust estate upon the death of the life tenant.

22.82 Currently the operation of the CGT provisions dealing with trust interests (including both life and remainder interests) arising upon or resulting from a person's death is unclear. As a consequence there is widespread uncertainty as to the proper CGT treatment of the interests in trusts when they are disposed of by life tenants and remaindermen.

22.83 Options for dealing with these problems are set out in Appendix B.

Treatment of asset transfers by an LPR

22.84 The existing policy is that there should be CGT rollover relief for direct generational transfers of assets between individuals where the transfer is a consequence of the death of one of the individuals, regardless of whether the transfer is via a testamentary trust. However, the provision for a CGT rollover from an LPR to a trustee of a testamentary trust and ultimately to the beneficiary offers a significant avenue for tax avoidance. In particular, it is possible to use the current rollover provisions to transfer property to taxpayers with perpetual lives such as companies or certain trusts. Tax on accrued gains can be deferred indefinitely if this is done.

22.85 The existing tax law provides that a CGT gain or loss made on the transfer of an asset upon the death of a person to their LPR is disregarded. Furthermore, the transfer by an LPR of an asset previously owned by the deceased person directly to a beneficiary, as a consequence of the completion of the administration of the deceased estate, would not give rise to a gain or loss for tax purposes.

22.86 There should continue to be relief from income tax where an LPR transfers an asset previously held by a deceased person to a natural person beneficiary (other than a person acting in the capacity as a trustee of certain types of trusts). The natural person beneficiary's cost base would be the same as the LPR's cost base if the LPR had disposed of the asset to a third party, rather than transferring it to the natural person beneficiary.

22.87 One way of addressing the problem of beneficiaries with perpetual life would be to treat the transfer by an LPR of an asset previously owned by the deceased person directly to a beneficiary that is not a natural person as a realisation of the asset by the LPR. The LPR would be treated as having disposed of the property for the market value of the asset. The LPR would have a cost base equal to the cost base that the deceased person would have had if they had disposed of the asset at the relevant time. Subject to consultation it may also be appropriate to include in this cost base any costs incurred by the LPR in disposing of the asset. The beneficiary should be treated as having acquired the asset for its market value at the date of transfer.

The only exception to this rule would be a transfer of property, beneficially owned by the deceased person at the time of their death, to a trust established by the will of the deceased person, provided the property is held on trust for the benefit of a natural person. Relief would be available in this latter situation.

22.88 The transfer by an LPR of assets not previously owned by the deceased person would be, as is currently the case, a realisation of the asset for taxation purposes.

Treatment of assets transferred by testamentary trusts to beneficiaries

22.89 There is a distinction between an LPR and a trustee for estate and trust law purposes. Because of that distinction the CGT rollover currently does not apply to asset transfers between a trustee of a testamentary trust and a beneficiary.

Option 1: Retain the existing treatment

22.90 Testamentary trusts would be treated as an entity under the proposed new entity tax system, and any assets transferred by the trust to a beneficiary would give rise to a realisation of the asset by the trustee. The beneficiary's cost base would be the market value of the asset at the date of the transfer. This would be the case even where the beneficiary was a natural person.

22.91 This result would be inconsistent with the proposal concerning transfers by a LPR, discussed above. However, this would ensure that testamentary trusts could not be used to defer the taxation of accrued gains indefinitely. The transfer would be treated in the same way as an in-kind distribution. The beneficiary would be treated as having acquired the asset for its market value at the date the asset is transferred to them.

Option 2: Apply similar treatment to that for LPRs

22.92 Another option would be to treat distributions by a testamentary trust in the same way as distributions by an LPR are taxed, provided:

- the property is held on trust for the benefit of a minor and is transferred to that minor within one year of the minor reaching the age of majority; or
- the property held on trust is transferred to a beneficiary who is a natural person (other than a person acting in the capacity of a trustee) within two years of the date of death of the person whose estate is being administered, or such longer period as agreed to by the Commissioner of Taxation.

22.93 If the rules set out above for whichever option is adopted are not satisfied by the testamentary trust, the transfer of an asset from a testamentary trust to a beneficiary would be treated as an in-kind distribution.

Treatment of transfers of principal residence

22.94 Another issue requiring consideration is the appropriate treatment of a deceased person's sole or principal residence, in circumstances where the residence is transferred to a testamentary trust by the LPR with no CGT relief available when ultimately transferred to a beneficiary. The lack of relief may arise because the conditions canvassed in the previous section are not satisfied by the testamentary trust.

22.95 Under the current law, the general principle is that capital gains on an individual's principal residence are not taxable. A range of special transitional provisions also applies when a dwelling is acquired by a taxpayer as a beneficiary of a deceased estate. For example, the principal residence exemption continues to apply if the dwelling is disposed of within twenty-four months of the date of death.

22.96 Generally, the current CGT principal residence exemption does not apply if the residence is owned by a trust or company rather than by an individual. However, where the LPR of a deceased person disposes of a dwelling, the principal residence exemption currently applies if either:

- the disposal takes place within the two year time limit specified by tax law; or
- the dwelling was, at all times following the person's death until its disposal, the principal residence of either the deceased person's spouse or a person who had a right of occupation under the will.

22.97 If the concessions currently available to LPRs are not extended to testamentary trustees, the full principal residence exemption would no longer apply once the LPR:

- transferred the property to a trustee of a testamentary trust; or
- became the trustee of the testamentary trust.

22.98 When the trustee transfers the property to the beneficiary there could be a realisation by the trustee for taxation purposes.

Option 1: Adopt LPR rules

22.99 In order to avoid this result, one option would be to adopt rules similar to those that apply to an LPR in the case of transferring a principal residence. Under this option, if the principal residency rules are not satisfied, the beneficiary would be treated as receiving an in-kind distribution.

A disposal to a third party, where the principal residence exemption does not apply, would be treated as a realisation by the trustee.

Option 2: Give a higher cost base to the trustee

22.100 Alternatively, the trustee could receive a cost base equal to the market value of the principal residence at the date of transfer to the beneficiary.

Appendix A

List of potential excluded trusts

A.1 A trust where all of the property which is the subject of the trust falls within one or more of the following categories:

- the property of a person who has become a bankrupt has been vested in The Official Trustee or a registered trustee in Bankruptcy under the *Bankruptcy Act 1966*;
- property is administered under Part XI of the *Bankruptcy Act 1966*;
- a court orders a trust (other than a child maintenance trust) to be set up to preserve the assets of, or provide an income stream to, a person suffering a legal disability or both; or
- a court orders a trust set up to administer the proceeds of crime or similar orders.

A.2 A trust that exists under the law of equity such that it would be reasonable to assume that the beneficiary (or beneficiaries) of the trust will acquire the property of the trust estate (other than as trustee) no later than when the trust ends, provided that the only income of the trust was from one or more of the following sources:

- the employment of a legally incapacitated person, provided that the legally incapacitated person is the sole beneficiary of the trust;
- property transferred to the trustee solely for the benefit of a person under a legal disability (for example, a child under the age of 18 years):
  - by way of, or in satisfaction of a claim for damages for
    - loss by the beneficiary of parental support through death or injury; or
    - personal injury to the beneficiary, any disease suffered by the beneficiary or any impairment of the beneficiary's physical or mental condition;
  - pursuant to any law relating to workers' compensation;
  - pursuant to any law relating to the payment of compensation in respect of criminal injuries;
  - directly as the result of the death of a person and under the terms of a policy of life insurance; out of a provident, benefit,

superannuation or retirement fund (provided that the property is transferred within two years from the death of the person or at a later date if the Commissioner of Taxation so determines);

- directly by an employer as the result of the death of an employee (provided that the property is transferred within two years from the death of the person or at a later date if the Commissioner so determines); or
- out of a public fund established and maintained exclusively for the relief of persons in necessitous circumstances;

- property that, in the Commissioner's opinion, represents accumulations of the following:
  - assessable income derived by the trustee during a year of income in relation to which modified Division 6 applies, being assessable income that, in relation to the beneficiary falls into one of the categories in the previous paragraphs;
  - assessable income derived by the trustee during the year of income in relation to which modified Division 6 (discussed above) does not apply, being assessable income that, in the Commissioner's opinion, in relation to the beneficiary would have fallen into one of the above categories if modified Division 6 (discussed above) had applied in relation to the year of income during which the assessable income was derived; or
  - exempt income derived by the trustee to which either of the two previous points would, in the Commissioner's opinion, apply if that exempt income had been assessable income.

A.3 A complying superannuation fund within the meaning of section 45 of the *Superannuation Industry (Supervision) Act 1993*, and a complying approved deposit fund within the meaning of section 47 of that Act.

A.4 Deceased estates (other than testamentary trusts) provided that the administration is completed within two years (or such longer period as the Commissioner determines) from the date of death and provided that they result from the following:

- a will, a codicil, or an order of a court that varied or modified the provisions of a will or codicil; or
- an intestacy or an order of a court that varied or modified the application, in relation to the estate of a deceased person, of the provisions of the law relating to the distribution of the estates of persons who die intestate.

Life tenants and remaindermen — interest created as a consequence of death

B.1 The following rules could be considered for interests created as a consequence of death. A trust need not exist in respect of all such interests.

B.2 If a life tenancy ceases due to either a disclaimer or surrender by the life tenant whether or not for consideration, such that the remainderman has an absolute entitlement to the asset, then there would generally be a realisation by the life tenant which is subject to tax. However, if the disclaimer or surrender occurred within one year of the creation of the life tenancy then there would be no realisation for taxation purposes.

B.3 Likewise, if the remainderman disposed of his or her interest in either the property, or the trust owning the property, to the life tenant whether or not for consideration, such that the life tenant has an absolute entitlement to the asset, there could generally be a realisation by the remainderman which is subject to tax. Again, if the disposal occurred within one year of the creation of the life tenancy, there would be no realisation.

B.4 If a life tenancy ceases due to the death of the person whose life determined the period of a life tenancy, and all the interests in the asset which was the subject of the life tenancy have merged so that the remainderman has an absolute entitlement to the asset, there would be no realisation for taxation purposes.

B.5 In all of the above cases, the life and remainder interests would be treated as having merged. The cost base of this merged asset would be the combined cost bases of the merged interests. The cost base of each of the interests would be the combined cost bases, if any, of the two interests.

B.6 In all other cases, if a life tenant disposes of his or her life interest in the property or the trust holding the property, there should be a realisation of the asset for taxation purposes.

B.7 The cost base of the life interest for the purchaser (other than the remainderman) would be generally the consideration actually paid for the transfer of the life tenant's interest.

B.8 There would be no tax consequences (either at the date of disposal or subsequently) where a life tenant disposes of either a life interest in their

principal place of residence or such an interest in a trust which owns their principal residence. In the case of a remainderman purchaser, the two interests would be treated as merged, with a cost base equal to the combined cost bases of the two interests.

B.9 In all other cases, if the remainderman disposes of his/her interest in the property, or in a trust that owns the property, there should be a realisation event.

B.10 The cost base of the remainder interest for the purchaser (other than the life tenant) would be generally the consideration actually paid for the transfer of that interest. In the case of a life tenant purchaser, the two interests would be treated as merged, with a cost base equal to the combined cost bases of the two interests.

B.11 In some cases in which a realisation occurs a life tenant, or remainderman, may not have a cost base in respect of his or her interest. Consideration needs to be given to possible methods of providing a cost base in situations where a cost base would be appropriate.