

‘Cloning’ of Trusts

The Tax Office has recently released Draft Tax Ruling TR 2005/D15, which explains the circumstances in which the beneficiaries and terms of two trusts are considered to be the same, so as to be exempt from CGT events E1 and E2.

The draft ruling considers the ‘cloning’ of a trust. Cloning involves establishing a new trust that is almost identical to the original and transferring one or more assets from the original trust to the new trust. Conversely, ‘splitting’ a trust does not involve the creation of a new trust, but the appointment of a new trustee in respect of some of the original trust’s assets. Such a course of action may result in amendments to the original trust’s deed, and a potential resettlement of the trust.

In practice, trusts are generally cloned or split for asset protection and family succession planning purposes. For family succession planning, it may be desirable to separate control over part of a trust’s assets for one member of the family, while control over the remainder is given to a different family member.

Under sections 104–55 and 104–60 of the *Income Tax Assessment Act 1997*, CGT event E1 occurs if a trust is created over a CGT asset, and CGT event E2 occurs if a CGT asset is transferred to an existing trust. However, under paragraphs 104–55(5)(b) and 104–60(5)(b), neither of these events occur if the asset is transferred to the trust from another trust and the beneficiaries and terms of both trusts are the same.

This draft ruling outlines the Tax Office’s view on what is required in order for the ‘beneficiaries and terms of both trusts’ to be the same. The following points are included:

- The beneficiaries must be the same.
- The beneficiaries must benefit in the same way. For example, if a direct beneficiary of the original trust becomes an indirect beneficiary of the new trust, they would not qualify for the exemption.
- If the original trust included an appointor, the deed of the new trust must also include an appointor and the position of appointor must be filled by the same person for both trusts.
- If the trustee of the original trust had the power of appointment of a replacement trustee, they would also need to be the trustee of the cloned trust.
- Both trusts must have the same vesting date.
- Both trusts must be governed by the same state laws.
- If the original trust has made a family trust election in respect of a certain individual, the new trust will also need to make a family trust election with respect to the same individual.

The draft ruling also discusses the features of the trusts that do not need to be the same:

- the trustee;
- the names of the trusts;
- the commencement dates of the trusts;
- the settlor; or
- the trust property.

The requirement is that the beneficiaries and terms of the two trusts must be the same at the transfer time. The transfer time encompasses the time immediately before and after the transfer. Consequently, it is necessary to compare the beneficiaries and terms of each trust immediately before and immediately after the transfer.

For further information, please review TR 2005/D15 — Income Tax: capital gains: meaning of the words ‘the beneficiaries and terms of both trusts are the same’ in paragraphs 104–55(5)(b) and 104–60(5)(b) of the *Income Tax Assessment Act 1997*, at:

<<http://law.ato.gov.au/atolaw/view.htm?find&docid=DTR/TR2005D15/NAT/ATO/00001>>.

Trust Distributions of Income or Capital

The Tax Office has recently issued Practice Statement LA 2005/1 (GA), which describes how the Commissioner will tax net capital gains derived by resident trust estates. This practice statement replaced PS LA 2004/3 as at 1 September 2005.

Proportionate Approach

The proportionate approach requires that a beneficiary (or a trustee on their behalf) be assessed on a capital gain included in the net income of the trust in proportion to their interest in the trust income.

Capital Beneficiary Approach

The capital gain may be assessed to a beneficiary (or a trustee on their behalf) where:

- the beneficiary has a vested and indefeasible interest in the trust capital representing the trust’s capital gain; or
- if the trust’s capital gain is a ‘deemed’ amount for tax purposes, the beneficiary would have had an interest if the gain were represented by actual trust capital; or
- the beneficiary has been allocated the trust’s capital gain as a present entitlement no later than two months after the end of the income year.

To use this approach the capital beneficiary must agree in writing that the approach be used and they must prepare their tax return in a way that corresponds to the agreement. The agreement must generally be made within two months after the end of the income year, or such further time as the Commissioner allows. The trustee resolution allocating the capital gain must also be made by the time the agreement is made.

Trustee Approach

If there is a capital gain that would not be included in the share of the net income of a beneficiary, the trustee will be assessed under section 99 or 99A.

This approach can only be used if beneficiaries and the trustee have agreed in writing to use it. Any agreement must be made within two months after the end of the relevant income year.

If a party does not prepare their income tax return in accordance with an agreement, the Tax Office will ignore the agreement in assessing the capital gain.

Practical Application

The practice statement applies to two distinct situations as discussed below.

Situation 1

The proportionate approach would result in an amount of capital gain being included in the assessable income of a beneficiary who has no entitlement to the gain.

For cases falling within Situation 1, the Tax Office will accept the proportionate approach, the capital beneficiary approach or the trustee approach.

Example

Trust A receives \$30,000 in net rental income and derives \$10,000 in non-discountable capital gains. The trustee decides to distribute the \$30,000 net rental income to Tom and the \$10,000 capital gain to Emily. Despite the fact that Emily was distributed the amount of the capital gain, the proportionate approach would include the \$10,000 capital gain in Tom's assessable income as Tom has a 100% interest in the income of the trust.

Situation 2

There is an amount of capital gain that would not be included in the assessable income of any beneficiary, but there is a beneficiary who has a vested and indefeasible interest in the amount of capital gain.

For Situation 2, only the capital beneficiary approach or the trustee approach will be accepted.

Example

Trust B receives a capital gain of \$20,000 and no other income. As the trust has not received any income (only capital) for the year, there is no amount of income that can be distributed to a beneficiary for tax purposes. Despite this, the trustee uses its power of capital advancement to appoint the \$20,000 to Sara. As there is no beneficiary that would be able to include the amount of the capital gain (as no beneficiary received income) the gain would ordinarily be taxed to the trustee.

The practice statement includes a flowchart summarising its application and several detailed examples of both situations.

For further information, please review PS LA 2005/1 (GA) — Taxation of capital gains of a trust, at:

<<http://law.ato.gov.au/atolaw/view.htm?find&docid=PSR/GA20051/NAT/ATO/00001>>.

Super Contributions and Part IVA

In the recently released Tax Determination TD 2005/29, the Tax Office has declared that Part IVA will generally not apply if a taxpayer pays excessive superannuation contributions relative to the value of services provided by a related employee.

The Tax Office has issued this determination in response to the decision in *Ryan v. Commissioner of Taxation* [2004] 56 ATR 1122. In this case, it was held that a company conducting a personal services business could make superannuation contributions to a related employee (the principal's wife) that exceeded the value of the work performed. The contributions were deductible as long as the total remained within the age-based limits. In addition, such a deduction could not be denied under Part IVA as its dominant purpose was to provide superannuation benefits and not to obtain a tax benefit.

The deductibility of superannuation contributions for employees is covered by section 82AAC of the *Income Tax Assessment Act 1936* (ITAA 1936). Under this section, such contributions are deductible where the contributions are made for the purpose of providing for superannuation benefits. The deductibility of contributions is restricted only by age-based limits.

This determination is equally applicable to businesses that are not personal services businesses. Of course, Part IVA may be applicable in situations where a contribution has been made for the purpose of omitting the income from an individual's assessable income or obtaining a deduction. This determination includes a detailed example of how the tax determination will apply to a personal services business.

For further information, please review TD 2005/29 — Income Tax: will Part IVA of the *Income Tax Assessment Act 1936* always apply if a taxpayer who carries on a business (including a personal services business) pays superannuation contributions that do not exceed the age-based limits but are considerably in excess of the value of the services provided by the employee?, at:

<<http://law.ato.gov.au/atolaw/view.htm?find&docid=TXD/TD200529/NAT/ATO/00001>>.

Amended Assessments Not Excessive

In a recent case, *Hobart Central Child Care Pty Ltd and Commissioner of Taxation* AATA 1027 [2005], the Administrative Appeals Tribunal has held that while the company didn't derive certain payments until the services were performed, the taxpayer failed to prove that the amended assessments were excessive.

The taxpayer provided childcare services and their income was made up of fees from parents for the services provided, and payments from the Commonwealth Government in accordance with the *Child Care Act 1972*. The fee income from the parents either represented full payment, or the part of payment not covered by the Commonwealth Government.

After completing a tax audit, the Tax Office issued the taxpayer with amended assessments for the 1993, 1994, 1995 and 1996 income years, which assessed an additional \$470,000 in income over this period. The amount was allegedly made up of undisclosed income and disallowed deductions (including deductions relating to private/domestic use of assets and motor vehicles).

The information contained in the lodged tax returns was provided by a director, Mrs Watson. In April 2003, Mrs Watson was convicted of three counts of defrauding the Commonwealth by substantially and knowingly understating the taxable income of the childcare centre. She was sentenced to seven months imprisonment and ordered to pay over \$130,000.

Despite this, the taxpayer objected to the amended assessments on the grounds that the amounts received from the Commonwealth Government in advance should not be treated as income until the time that the services are provided. The taxpayer contended that to the extent that they had spent some of these funds, it was in the form of a loan from the government and so did not constitute income to the taxpayer until services were provided.

In response, the Tax Office contended that the payments made by the Commonwealth were income upon receipt.

In order for the AAT to rule in the favour of the taxpayer, the taxpayer had to discharge the burden of proof that the assessments were excessive. The taxpayer referred to the *Arthur Murray* principle, which states that fees received in advance are only assessable when the service is provided.

The AAT agreed that the taxpayer had a valid point in arguing that the *Arthur Murray* principle was relevant, but queried whether its application would result in the assessments not being held to be excessive. The AAT concluded that even if the principle did apply, it would be logical that the derivation of income would just move to subsequent periods and the overall amount of assessable income would remain the same across the period in question. The taxpayer failed to discharge the burden of proof and the AAT ordered that the amended assessments stand.

For further details, see:

<www.austlii.edu.au/au/cases/cth/aat/2005/1027.html>.

Assessability of New Zealand Company Income

The Tax Office has recently released Interpretative Decision ATO ID 2005/289, which indicates that income derived by a New Zealand company from the sale of products in Australia is assessable income where the company is carrying on business in Australia through a permanent establishment.

The taxpayer was a New Zealand company that was a resident of New Zealand for tax purposes, and not Australia. The company sold goods in Australia through two employees. As the company did not own or rent any premises in Australia, the two employees used rooms in their respective residences to process company business. The employees passed on orders to the head office in New Zealand via phone, email and fax. The head office dispatched the ordered goods directly to the customer.

Under subsection 6–5(3) of the *Income Tax Assessment Act 1997*, the assessable income of a non-resident taxpayer includes all income directly or indirectly from Australian sources during the income year, and this includes income from the sale of goods.

In addition to the Australian Income Tax Assessment Acts, reference must be made to the *International Tax Agreements Act 1953* and, in particular, the Australia–New Zealand Double Tax Agreement (DTA). Under Article 7 of the DTA, the business profits of a New Zealand enterprise shall only be taxable in New Zealand unless the enterprise carries on a business in Australia through a permanent establishment situated in Australia.

In a US case, *Georges Simenon v. Commissioner* [1965] 44 TC 820, a US tax court held that a home office was a fixed place of business through which an enterprise is carried on and, as such, constituted a permanent establishment. Consequently, the Tax Office has declared that the New Zealand company, while not owning or renting property in Australia, is operating an enterprise through a fixed place of business and thus satisfies the definition of permanent establishment under Article 5(1).

For further information, please review ATO ID 2005/289 — Assessability of income derived by a New Zealand resident company, at:

<<http://law.ato.gov.au/atolaw/print.htm?find&docid=AID/AID2005289/00001>>.

GST — Changes in Extent of Creditable Purpose and Adjustments

In draft ruling GSTR 2005/D7, the Tax Office provides a detailed explanation of the meaning of ‘creditable purpose’ and ‘extent of creditable purpose’ for the purposes of Divisions 11, 15 and 129 of the *A New Tax System (Goods and Services Tax) Act 1999* (the GST Act). This ruling will replace GSTR 2000/15 from its date of issue as a final ruling.

Under the GST Act, an entity is only entitled to an input tax credit for GST incurred in making creditable acquisitions or importations. Sections 11–5 and 15–5 detail the requirements that need to be satisfied in order for an acquisition or importation to be creditable. The draft ruling only considers the requirements in subsections 11–5(a) and 15–5(a), which require the acquisition or importation to be made solely or partly for a creditable purpose.

A creditable purpose is defined in section 11–15 (for acquisitions) and section 15–10 (for importations). Both sections provide that:

- (i) you acquire a thing or import goods for a creditable purpose to the extent that you do so in carrying on your enterprise; and
- (ii) you do not acquire a thing or import goods for a creditable purpose to the extent that:
 - (a) the acquisition or importation was related to making supplies that would be input taxed; or
 - (b) the acquisition or importation is of a private or domestic nature.

Extent of Creditable Purpose

According to the Tax Office, the phrase, 'extent of creditable purpose' is defined to mean 'the extent to which the creditable acquisition or importation is for a creditable purpose, expressed as a percentage of the total purpose of the acquisition or importation'. Further, the phrase 'to the extent that' requires an apportionment to be made where the acquisition or importation is used only partly for a creditable purpose. In order to apportion the input tax credits, there is a need to determine the planned extent of creditable purpose.

Acquisitions and Importations Made in Carrying on an Enterprise

In order to be acquired for a creditable purpose, the acquisitions and importations also need to be made in carrying on an enterprise, the definition of which in section 9–20 of the GST Act includes an activity or series of activities done in the form of a business. Further, the acquisitions and importations need to be made for the purpose of that enterprise. Where the acquisitions are made in carrying on an enterprise, but are not directly linked to making particular supplies (they relate indirectly to all activities of the enterprise), there is still a need to apportion the input tax credits across taxable, input taxed and GST-free supplies.

Acquisitions or Importations of a Private or Domestic Nature

The Tax Office is of the view that an acquisition or importation is of a private or domestic nature if it:

- has not been incurred in gaining or producing assessable income; or
- was not necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income.

Some examples of expenses that are generally of a private or domestic nature include:

- travel expenses to and from work;
- expenses for the necessities of life (such as food, clothing and shelter);
- self education;
- child care fees; and
- home office expenses such as rent, interest and electricity.

Making Adjustments when your Actual Extent of Use for a Creditable Purpose is Different from your Planned Use

When the actual extent of use for a creditable purpose is different from your planned use, there is a need to make an adjustment under Division 129 of the GST Act. However, there is no requirement to make an adjustment where the GST-exclusive value of an acquisition or importation:

- is \$1,000 or less (if it does not relate to business finance); or
- is \$10,000 or less (if it does relate to business finance).

There is also no adjustment required where the goods had previously been applied solely to private or domestic use.

General Principles of Apportionment

The method of apportionment chosen needs to:

- be fair and reasonable for the entity's circumstances;
- reflect the planned use of that acquisition (or the actual use in relation to adjustments); and
- be adequately documented.

Choosing a Method for Determining the Extent to which an Acquisition or Importation is Applied for a Creditable Purpose

When choosing a method for determining the extent to which an acquisition or importation is applied for a creditable purpose, there is a need to consider:

- the nature of the acquisition or importation and the ways that use of this acquisition or importation can be measured on a direct basis; and
- the value of the acquisition or importation and the cost of measuring it on a direct basis.

Types of Methods for Determining the Extent of Use for a Creditable Purpose

There are a number of methods that can be used in order to determine the extent of creditable purpose of an acquisition or importation. These include:

- direct methods:
 - distance;
 - time;
 - volume;
 - space; and
 - staff number;
- indirect methods:
 - input-based; or
 - output-based; and
- a method that has already been applied under income tax law.

It should be noted that the apportionment method chosen should not produce significant distortions, i.e. it needs to give a fair and reasonable reflection of the extent of creditable purpose.

Record Keeping — General Requirements

In GSTR 2005/D7, the Tax Office provides that there is a requirement to maintain a record of ‘any election, choice, estimate, determination or calculation made’, including particulars of the above and the basis on which the ‘estimate, determination or calculation was made’. Further, the records need to be maintained for a period of five years after the completion of the transaction to which the records relate.

For further information, please view Draft GST Ruling GSTR 2005/D7 — Goods and services tax: determining the extent of creditable purpose for claiming input tax credits and for making adjustments for changes in extent of creditable purpose, at:

<<http://law.ato.gov.au/atolaw/view.htm?find&docid=DGS/GST2005D7/NAT/ATO/00003>>.

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