EXPOSURE DRAFT

NEW BUSINESS TAX SYSTEM (ENTITY TAXATION) BILL 2000

EXPLANATORY MATERIAL

(Circulated by authority of the
Treasurer, the Hon Peter Costello, MP)

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Glossary

The following abbreviations and acronyms are used throughout this Explanatory Material.

Abbreviation	***Definition***
A Tax System Redesigned	*Review of Business Taxation: A Tax System Redesigned*
AEST	Australian eastern standard time
ANTS	Government's Tax Reform Document: *Tax Reform: not a new tax, a new tax system*
CGT	capital gains tax
Commissioner	Commissioner of Taxation
FBT	fringe benefits tax
FBTAA 1986	*Fringe Benefits Tax Assessment Act 1986*
ITAA 1936	*Income Tax Assessment Act 1936*
ITAA 1997	*Income Tax Assessment Act 1997*
PAYG	pay as you go
TAA 1953	*Taxation Administration Act 1953*
the Review	Review of Business Taxation

Chapter 1
Overview of the entity tax regime applying to non-fixed trusts

Outline of Chapter

1.1 This Chapter provides an overview of Part 3-5. Part 3-5 introduces the entity tax regime applying to non-fixed trusts. The regime will replace the current rules applying to non-fixed trusts under Division 6 of the ITAA 1936.

1.2 The regime will provide rules for the treatment of distributions, and other transactions between those entities and their members, rules that are broadly comparable to those applying to companies under the ITAA 1936.

1.3 The entity regime applying to non-fixed trusts implements the recommendation made by ANTS to tax trusts like companies and is broadly consistent with the Review's recommendations in its report, *A Tax System Redesigned*.

1.4 The particular measures are discussed in more detail in the succeeding Chapters of this Explanatory Material.

Context of reform

1.5 The entity regime applying to non-fixed trusts aims to improve both the integrity and the fairness of our income tax law.

1.6 It will do that by clawing back tax preferences generated by a non-fixed trust in a manner consistent with the rules that apply to companies.

1.7 Some types of trusts will continue to receive a different treatment to that applying to non-fixed trusts. These trusts are:

- fixed trusts – due to their nature, these trusts will continue to receive flow-through treatment under the existing Division 6 provisions contained in the ITAA 1936;
- superannuation entities – this different treatment exists to encourage savings for retirement; and

- certain specified trusts referred to as excluded trusts (even if they are non-fixed trusts) – these may be trusts brought about by court orders, death, the need to provide for people with legal disabilities, and so on. Usually in such cases, a trust is the only type of entity available and they are not used for commercial activities. Rules providing for these types of trusts will be the subject of future amendment.

What is the new entity treatment applying to non-fixed trusts?

1.8 The rules are designed to ensure that tax preferences generated by a non-fixed trust are clawed back in a manner consistent with the rules that apply to companies. This is achieved by taxing non-fixed trusts at the entity level and imputing the tax paid to its members. Income distributed to members that is not taxed at the entity level is taxed to the member, subject to certain specific exclusions.

Distributions

1.9 Generally, distributions from a non-fixed trust will be treated as coming first from its available profits and then from its contributed capital. This is called ‘the profits first rule’. It is based on the idea that the members have access to the ongoing profits of the non-fixed trust.

1.10 However, distributions in consideration of members giving up their interests in the non-fixed trust will usually be treated as coming first from contributed capital. This is called ‘the slice rule’. It recognises that members lose their share of the non-fixed trust’s contributed capital, as well as its profits, when they give up their interest.

Imputation

1.11 The current imputation rules for companies have been rewritten and extend to non-fixed trusts. These rules are explained in Chapter 7. Broadly, those rules ensure that the total income tax on a member’s share of a non-fixed trust’s *distributed* profits will be limited to the member’s marginal tax rate.

Summary of new law

1.12 Part 3-5 will provide rules for the treatment of non-fixed trusts and of the distributions they make to their members. The key features are summarised below.

What is a ‘non-fixed trust’?	A trust is a ‘fixed trust’ if persons 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.

Do non-fixed trusts pay tax?	Yes. Non-fixed trusts will be liable for income tax at the prevailing company tax rate (30% from the 2001-2002 income year).
What happens when they make a distribution?	A distribution from a non-fixed trust is divided up in its members' hands between available profits, a return of contributed capital and, in some rare cases, trust amounts that the members have already paid tax on.
What is a 'distribution'?	Broadly, a distribution includes the payment of money or the transferring of property to a member. There are also some other specific inclusions.
Who are 'members'?	Members of a non-fixed trust are: • beneficiaries and objects of trusts; • holders of interests that carry rights to manage or control the entity; and • holders of rights under a loan to a non-fixed trust that gives rise to a contribution of capital to the non-fixed trust.
How is a distribution divided up in the members' hands?	Distributions in consideration of losing membership interests are divided up using 'the slice rule'. They are treated as a distribution of contributed capital to the extent of the membership interest's share of the non-fixed trust's contributed capital. Any excess is treated as a distribution of profits. Other distributions are treated as distributions of available profits to the extent the non-fixed trust has those and any excess is treated as a distribution of contributed capital. However, the non-fixed trust can also choose to distribute prior taxed amounts instead of available profits.
What are 'available profits'?	Available profits is the difference between the market value of the non-fixed trust's assets and its liabilities less certain other amounts.
What is 'contributed capital'?	Contributed capital is the amount that has been contributed or settled in the non-fixed trust, less the amount of such contributions that have been returned. There are also some specific rules to preserve the CGT treatment of certain assets that the trust holds before the introduction of these rules.
What are 'prior taxed amounts'?	A prior taxed amount is an amount held by a trustee on which tax has already been paid by, or for, the member.
How is a distribution of available profits treated?	Distributions of available profits are assessable income for taxable members.

How is a distribution of contributed capital treated?	Distributions of contributed capital to holders of membership interests in a non-fixed trust will reduce the cost base of that membership interest and may be treated as a capital gain to the extent that it exceeds the cost base. Special rules will apply to distributions of contributed capital to members holding certain discretionary interests.
How is a distribution of a prior taxed amount treated?	Distributions of prior taxed amounts are generally not assessable income and generally do not reduce carry-forward losses.

Comparison of key features of new law and current law

1.13 This table sets out the key differences between the current law and the rules in the entity tax regime applying to non-fixed trusts. Some of these key differences are subject to exceptions that are explained in the other Chapters of this Explanatory Material.

New law	***Current law***
Non-fixed trusts will be taxed like companies. Their distributions will be taxed like company dividends. Corporate unit trusts and public trading trusts will continue to be taxed like companies under the existing provisions contained in Divisions 6B and 6C of the ITAA 1936.	The net income of a trust is usually taxed to the beneficiaries who are presently entitled to the trust's net income. Net income to which no beneficiary is presently entitled is taxed to the trustee. Corporate unit trusts and public trading trusts are taxed like companies.
'Member' will be used to refer to investors in non-fixed trusts.	The term used for investors in a non-fixed trust is 'beneficiary'.
'Distribution' will be used to refer to the benefits that non-fixed trusts transfer to their members.	Beneficiaries are taxed, not on transfers of benefits, but on their share of the trust's net income.
Most distributions will be taken to be distributions of profits to the extent possible and then of contributed capital.	Trust beneficiaries are taxed on their share of the trust's net income.
Non-fixed trusts must keep an account of the contributed capital of each class of membership interest.	There is no general requirement to keep contributed capital accounts.
Non-fixed trusts (and companies) will be able to pass imputation credits to their members, along with their distributions.	The imputation system only applies to companies and dividends and to entities that are treated like companies (e.g. public trading trusts).

Detailed explanation of new law

1.14 The new entity regime applying to non-fixed trusts deals with the taxation of those trusts and with transactions between them and their members.

Key features of the entity regime applying to non-fixed trusts

Taxing the non-fixed trust

1.15 Non-fixed trusts will be liable for tax on their taxable income. In general terms, they will work out their taxable income in the same way as a company or entity taxed like a company.

1.16 Paying that tax will generate imputation credits in their franking accounts.

1.17 Amounts contributed or settled to a non-fixed trust in respect of membership interests in it will not be included in its assessable income. They will increase its contributed capital account.

1.18 Unlike the current rules applying to tax treatment of trusts, non-fixed trusts will not be under any obligation to distribute their profits (or anything else) to their members and there will be no tax consequences if they choose not to.

Distributions to members

1.19 Non-fixed trusts can distribute benefits to their members. Consistent with the current rules that apply to companies, distributions taking the form of payments of money or the transfer of property and certain other specific inclusions will be recognised and taxed appropriately.

1.20 The tax effect when members receive a distribution will depend on the source of the distribution and on the imputation credits attached.

Source of distributions – the profits first rule

1.21 The primary rule is that distributions are taken to be made out of the non-fixed trust's available profits to the extent possible. That way of dividing up a distribution is called 'the profits first rule'. ***Available profits*** is the amount by which the market value of the trust's assets exceeds its liabilities less certain other amounts including contributed capital. Therefore, its available profits include unrealised gains.

1.22 Once the available profits are used up, the rest of the distribution is contributed capital to the extent of contributed capital available. ***Contributed capital*** is the amount contributed or settled to a non-fixed trust in respect of membership interests in it, less any such amounts returned to members. Once the contributed capital of the entity is used up, the remainder of the distribution is taken to be from unfrankable profits.

1.23 Distributions out of profits are assessable income of most members. However, the income of some members (e.g. religious or charitable institutions) will stay exempt in accordance with the existing law.

1.24 Distributions out of contributed capital reduce the cost of the fixed membership interest. Therefore, in the case of a fixed interest in a non-fixed trust (i.e. a hybrid trust), distributions of contributed capital are generally not assessable income but instead reduce the cost of the membership interest. This will increase gains when the interest is eventually sold. If the cost is reduced to zero, any excess will usually be a capital gain.

1.25 In the case of discretionary interests in a non-fixed trust, provided certain conditions are met, returns of contributed capital are not assessable nor do they reduce the cost base of the relevant membership interest.

Source of distributions – prior taxed amounts

1.26 A non-fixed trust may have accumulated amounts on which tax has already been paid by a beneficiary or by the trustee including on a beneficiary's behalf. Such amounts (prior taxed amounts) can be distributed to the beneficiary tax free.

1.27 A trust can choose to distribute a prior taxed amount even if it has available profits.

Source of distributions – the slice rule

1.28 Distributions in consideration of a member giving up a membership interest do not use the profits first rule. Instead, they are treated as coming out of contributed capital to the extent of that interest's share of the non-fixed trust's contributed capital. Any excess is treated as a distribution out of available profits. That way of dividing up a distribution is called 'the slice rule'.

Effects of imputation credits

1.29 Companies and non-fixed trusts can attach imputation credits to distributions out of available profits. It gets those credits by paying income tax or by receiving credits attached to a dividend or distribution from another entity. These rules are explained in Chapter 7.

1.30 Some members will have a marginal tax rate lower than the corporate tax rate. Most such members can use the excess to reduce their tax on other income (provided certain anti-avoidance provisions are not triggered). If they have insufficient other income, they can get a refund of the unused imputation credits.

Membership interests

1.31 ***Membership interests*** are the interests in a non-fixed trust that makes someone a member of that entity (e.g. a beneficiary of a non-fixed trust).

Further detail about the entity regime applying to non-fixed trusts

1.32 The above key features, and some other concepts are discussed in detail in the following Chapters.

Table 1.1: Further details about non-fixed trusts

Topic	***Chapter***
Non-fixed trusts and their members	2
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Taxing distributions from non-fixed trusts	5
Contributed capital	6
The new imputation system	7
Franking credits for foreign withholding tax	8
Transitional restructure relief: fixed trusts and companies	9
Primary production averaging	10
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Application and transitional provisions

1.33 The entity regime applying to non-fixed trusts will apply from 1 July 2001.

1.34 Transitional measures will ensure that the rules do not inappropriately affect existing trusts. In particular, they will maintain the existing treatment for assets acquired by trusts before 23 December 1999 both for gains on pre-CGT assets and post-CGT assets. The amount of any gain untaxed under the current law will be added to the trust's contributed capital.

1.35 There are also transitional measures for certain entities that restructure in the period prior to the commencement of the non-fixed trust regime. These measures allow for roll-over relief for asset transfers by:

- a fixed trust to a company; or
- a widely-held company to a widely-held fixed trust,

where the underlying ownership of those assets does not change.

1.36 Members of the original entity who receive replacement interests in the new entity may also benefit from roll-over relief. The transfers of assets must occur before 1 July 2001, and the original entity must cease to exist following the asset transfer.

1.37 There will be no capital gains consequences for such transfers if the conditions are met. Broadly, the capital gains values of the assets will be transferred to the new owners. Similarly, the transfer of trading stock will not have revenue consequences for the transferor.

1.38 There will be no capital gains consequences for members whose interests are converted into interests in a new entity in such a restructure. The capital gains values of their old interests will pass to the new ones.

1.39 The rules discussed in this exposure draft legislation do not entirely codify all the necessary rules for the entity regime applying to non-fixed trusts. Areas in which further rules are being developed include:

- rules for taxation of excluded trusts and in relation to the cessation of trusts;
- international tax measures; and
- appropriate machinery provisions for the proper collection and recovery of tax in respect of non-fixed trust distributions.

1.40 The international tax aspects of the entity regime applying to non-fixed trusts in which further rules are being developed include:

- modifying the residency test for non-fixed trusts;
- taxing distributions made by non-resident non-fixed trusts to non-resident members out of profits derived from sources in Australia;
- extending exemptions for foreign branch profits and certain distributions from non-resident non-fixed trusts to new non-fixed trusts;
- replacing the foreign dividend account measures with foreign income account rules to provide relief from Australian withholding tax on certain foreign income that flows through resident non-fixed trusts to non-residents;
- applying the Australian withholding tax regime to all distributions by resident non-fixed trusts to non-residents;
- aligning the *International Tax Agreements Act 1953* with the entity regime applying to non-fixed trusts;
- aligning the foreign source income measures, including provisions dealing with deemed distributions, with the entity regime applying to non-fixed trusts; and
- reviewing the franking credit provisions for tax paid on transfer pricing adjustments.

Chapter 2
Non-fixed trusts and their members

Outline of Chapter

2.1 This Chapter explains which trusts are non-fixed trusts and thus subject to the non-fixed trust regime. It also explains who is a member of a non-fixed trust and the nature of the membership interest which a member may have.

Context of reform

2.2 The non-fixed trust regime will apply to non-fixed trusts. The concept of a non-fixed trust is the major building block of the new regime.

2.3 A key feature of the new regime is that a non-fixed trust is recognised as a taxable entity despite its lack of legal personality. The new regime taxes non-fixed trusts similar to the manner in which companies are taxed – at the entity level. Distributions by a non-fixed trust to its members, and contributions of capital by members to a non-fixed trust, do not generally affect the trust's taxable income. Most other trusts will continue to receive flow-through treatment under Division 6 of the ITAA 1936.

2.4 As part of the move towards entity treatment of non-fixed trusts, there will be a common name for trust objects and beneficiaries. They will be referred to as members.

2.5 The identity of the members of non-fixed trusts is relevant because:

- distributions received by them may be taken into account in working out their taxable income;
- distributions received by an associate of the member may be taxed in the hands of that associate; and
- contributions they make to the non-fixed trust in exchange for obtaining or enhancing a membership interest in the trust will become part of the trust's contributed capital.

Summary of new law

2.6 Only non-fixed trusts will be taxed like companies under the new regime. The rules are summarised here.

Which trusts are covered by the new regime?	Most non-fixed trusts.
Which trusts are excluded?	Trusts which are not covered by the new regime are: • fixed trusts; and • certain trusts that are excluded.
Who is a member?	In broad terms, a member of a non-fixed trust is an entity who: • is a discretionary object or a beneficiary of a non-fixed trust; • has a right to participate in the management or control of a non-fixed trust (otherwise than as a trustee); or • is a holder of a right under a loan to the non-fixed trust that gives rise to a contribution of capital to the non-fixed trust.
Examples of members…	A discretionary object of a trust will be a member of the trust. A beneficiary with a fixed entitlement under a trust that has both fixed and non-fixed elements (hybrid trusts) will also be a member.
What is a membership interest?	A membership interest is each right or interest a member has because they are a member.

Detailed explanation of new law

2.7 The non-fixed trust regime will apply to non-fixed trusts.

2.8 However, not all non-fixed trusts will be subject to the new regime. Essentially these trusts, called excluded trusts, are created in circumstances where there was no choice to use a structure other than a non-fixed trust structure. Rules explaining what trusts are excluded trusts are to follow. ***[Schedule 1, item 23, subsection 153-25(1)]***

2.9 Once a trust becomes subject to the non-fixed trust regime then it will continue to be subject to the non-fixed trust regime until it terminates (by way of resettlement, complete vesting or otherwise). Thus, even if a non-fixed trust becomes fixed (e.g. by removing a discretion from a trust deed) or becomes an 'excluded' trust, it will still continue to be subject to the non-fixed trust regime. This ensures that trusts cannot swap between treatment under the non-fixed trust regime and treatment under Division 6 of the ITAA 1936 whenever it is advantageous to do so. ***[Schedule 1, item 23, subsections 153-25(2) and (3)]***

What is a non-fixed trust?

2.10 The term 'non-fixed trust' is defined in subsection 995-1(1). ***[Schedule 7, item 58, definition of 'non-fixed trust' in subsection 995-1(1)]***

2.11 The definition explains that a ***non-fixed trust*** is any trust which is not a fixed trust. A trust is a 'fixed trust' if entities have fixed entitlements to all of the income and capital of the trust ***[Schedule 7, item 25, definition of 'fixed trust' in subsection 995-1(1)]***. It follows that trusts that have both fixed and non-fixed elements (hybrid trusts) are also non-fixed trusts for the purposes of the proposed legislation. For example, where some part of the income or capital of a trust may be distributed at the discretion of the trustee or another entity, the trust is *not* a fixed trust.

What is a fixed entitlement to income or capital?

2.12 'Fixed entitlement' takes the meaning provided in Division 272 of Schedule 2F of the ITAA 1936 (the trust loss provisions) ***[Schedule 7, item 23, definition of 'fixed entitlement' in subsection 995-1(1)].*** An entity will have a fixed entitlement to either income or capital of a trust (whichever is applicable) where the entity has a vested and indefeasible interest in a share of the income of the trust that the trust derives from time to time (i.e. current and future income), or a share of capital of the trust (subsection 272-5(1) of the ITAA 1936). The share that the person has an interest in is expressed as a percentage of the total income or capital (whichever is applicable) of the trust.

What is a vested interest?

2.13 A beneficiary has a vested interest in something if the beneficiary has a present right relating to the thing. Stated simply, a vested interest is one that is bound to take effect in possession at some point in time. A vested interest is to be contrasted with a 'contingent' interest which may never fall into possession. If an interest of a beneficiary in income or capital is the subject of a condition precedent, so that an event must occur before the interest becomes vested, the beneficiary does not have a vested interest to the income or capital since such an interest is instead 'contingent' upon the event occurring.

2.14 Broadly speaking, a beneficiary can be said to be either 'vested in possession' or 'vested in interest'. A present interest, that is, one that is being enjoyed, is said to be 'vested in possession'; a future interest, that is, one which gives its holder a present right to future enjoyment, is said to be 'vested in interest'. A beneficiary is vested in possession where the beneficiary has a right to immediate possession or enjoyment of the thing in question. In the definition of fixed entitlement, 'vested' includes both vested in possession and vested in interest.

2.15 Because vested interests include future interests, a beneficiary can have a vested interest in a thing even though the beneficiary's actual possession and enjoyment of the thing is delayed until some time in the future.

When is a vested interest indefeasible?

2.16 A vested interest is indefeasible where, in effect, it is not able to be lost. A vested interest is defeasible where it is subject to a condition that may lead to the entitlement being divested. For example, an event that could occur after the interest is vested that would result in the entitlement being defeated. Where a beneficiary's vested interest is able to be taken away by the exercise of a power by the trustee or any other person, the interest will not be a fixed entitlement.

2.17 Where the trustee exercises a power to accumulate income or capital of the trust in accordance with the trust deed, the accumulation does not result in a beneficiary's interest being taken away or defeased as long as the beneficiary nevertheless remains entitled at some future time to enjoy his or her share of the income or capital which has been accumulated.

Example 2.1

> A unit trust has 100 units. All of the units carry equal rights to income and capital of the trust. The trustee has no discretion to allocate income or capital of the trust to unit holders other than in accordance with the share of income and capital represented by their units. The trustee has the power to accumulate income of the trust if the majority of the unit holders agree to such accumulation. However, each unit holder retains their interest in the share of accumulated income represented by their units. All of the income and capital of the unit trust is subject to fixed entitlements. The mere fact that the income of the trust is accumulated in the trust in accordance with the terms of the trust deed does not prevent the beneficiaries of the trust from being treated as having a vested and indefeasible interest in the income or capital of the trust.

The mere fact that units can be issued or redeemed at market value does not mean an interest is defeasible

2.18 Subsection 272-5(2) of the ITAA 1936 clarifies that the interest of a unit holder in a unit trust will not taken to be defeasible only because units in a unit trust can be issued or redeemed. However, for this clarifying provision to operate, the issue or redemption of the units must be at full value. This means that additional units could be issued or units redeemed only for market value or for a price that represents the net asset value of the trust. For listed unit trusts, market value of the units would be the listed price. For other unit trusts, the units need to be issued or redeemed at a value representing the net asset value of the trust.

2.19 Subsection 272-5(2) of the ITAA 1936 is not intended to disturb the ordinary meaning of 'vested and indefeasible interest' in any way except in accordance with its terms. Thus, if an interest is vested and indefeasible ignoring subsection 272-5(2) of the ITAA 1936, it will be a fixed entitlement.

Commissioner's discretion to treat an entitlement as not being able to be varied

2.20 Under subsection 272-5(3) of the ITAA 1936, the Commissioner has a discretion to determine that an interest of a beneficiary to income or capital that is not vested and indefeasible can be treated as vested and indefeasible. This in turn means the interest could be treated as a fixed entitlement. The Commissioner could exercise this power having regard to:

- the circumstances in which the beneficiary's interest would not become vested or would be defeased;
- the likelihood of the interest not vesting or not being defeased; and
- the nature and type of the trust.

2.21 This discretion provides for special circumstances where there is a low likelihood of a beneficiary's vested interest being taken away or defeated and it would be unreasonable to treat the interest as being non-fixed, and hence the trust as non-fixed, for the purposes of the non-fixed trust regime.

Who is a member of a non-fixed trust?

2.22 Section 960-120 explains who are members of a non-fixed trust. These are:

- a discretionary object of a non-fixed trust ***[Schedule 7, item 1, subsection 960-120(1), item 5(a) in the table]***;
- a beneficiary of a non-fixed trust ***[Schedule 7, item 1, subsection 960-120(1), item 5(b) in the table]***;
- a holder of a right to participate in the management or control of a non-fixed trust ***[Schedule 7, item 1, subsection 960-120(1), item 5(c) in the table]***; and
- a holder of a right under a loan to a non-fixed trust that gives rise to a contribution of capital to the non-fixed trust ***[Schedule 7, item 1, subsection 960-120(1), item 5(d) in the table]***.

2.23 Any entity may be a member of a non-fixed trust. For example, the member may be an individual, a company, another non-fixed trust, a superannuation fund or an excluded trust.

Object or beneficiary of a non-fixed trust

2.24 A beneficiary or a discretionary object of a non-fixed trust is a member of the trust. ***[Schedule 7, item 1, subsection 960-120(1), items 5(a) and (b) in the table]***

2.25 A discretionary object has an interest in the proper administration of the trust because they are the object of a discretion that can be exercised by the trustee. Strictly speaking they are not beneficiaries – they have no interest in the income or capital of the trust until the trustee exercises a discretion in their favour. For that reason, it is necessary to refer to both beneficiaries and discretionary objects as potential members of a non-fixed trust.

Right to participate in management or control of the non-fixed trust

2.26 A member of a non-fixed trust includes the holder of a right to participate in the management or control of the trust. However, it does not include a person who holds that right as a trustee. ***[Schedule 7, item 1, subsection 960-120(1), item 5(c)]***

2.27 This ensures that the management or control rights that naturally attach to trustee positions are not sufficient to make those persons members. However, this does not prevent trustees being members on some other basis, for example, because a trustee is also a beneficiary, or because they also have other unrelated rights to manage or control.

A holder of a right under a loan to the non-fixed trust

2.28 A member that makes a non-commercial loan to a non-fixed trust, or a commercial loan where the annual interest requirements are not met or is not fully repaid by the end of the term or is forgiven, is taken to contribute capital to the non-fixed trust ***[Schedule 1, item 23, sections 157-115, 157-120 and 157-135]***. This is because these loans, in substance, take the place of subscribing for membership interests.

2.29 Therefore, such loans are treated as equity and not debt. The member acquires an additional membership interest in the non-fixed trust when the loan is non-commercial or is not fully repaid. ***[Schedule 1, item 23, subsection 157-140(1); Schedule 7, item 1, subsection 960-120(1), item 5(d)]***

Joint membership

2.30 If 2 or more entities jointly hold interests or rights that give rise to membership of a non-fixed trust, each of them is a member ***[Schedule 7, item 1, subsection 960-120(2)]***. This covers the situation where 2 or more entities together jointly hold the interests or rights giving rise to membership. It will not cover the situation where 2 or more hold rights or interests which would amount to membership only if those rights or interests were taken together, and they do not hold the rights or interests jointly.

What is a membership interest?

2.31 A member of a non-fixed trust has an asset that is described as a ***membership interest*** which is each right or interest, or each set of rights or interests, they have because they are a member. ***[Schedule 7, item 1, section 960-125]***

Class of membership interest

2.32 Membership interests that carry strictly identical rights to distributions are part of a single class. Only the rights to distributions need be equal. Other rights, such as voting rights, may be different. ***[Schedule 7, item 11, subsection 995-1(1), definition of 'class]***

2.33 Determining classes of membership interests is relevant to calculating the slice of the non-fixed trust being distributed as part of extinguishing a membership interest (see Chapter 4).

Application and transitional provisions

2.34 The non-fixed trust regime will apply from 1 July 2001.

Consequential amendments

Tax is payable on the trust's taxable income

2.35 A key feature of the new regime is that non-fixed trusts, unless they are excluded or exempt will pay tax on their taxable income. Tax will be paid at the prevailing corporate rate, which is 30% for the 2001-2002 income year.

2.36 To ensure this occurs consequential amendments to sections 3-5, 4-1, 9-1 and 9-5 of the ITAA 1997 have been made. ***[Schedule 1, items 1 to 22]***

Applying the rules to entities that are not legal persons

2.37 As non-fixed trusts are not separate legal persons, translator provisions are necessary to assist in applying the Act to them. These provisions create a set of equivalents for things done by or in relation to non-fixed trusts ***[Schedule 1, item 23, section 159-10]***. They ensure that the actions of the trustee of the non-fixed trust are recognised as actions undertaken by the trust and that assets and liabilities trustees hold on behalf of the trust are treated as being those of the trust. The rules also identify what assets are to be taken as assets of the trust.

2.38 The term 'representative' is used to refer to the trustee or any trustees acting as the trustee of the trust.

2.39 What such representatives do in their representative capacity is done by the trust, and what is done to or in relation to such representatives in their representative capacity is done to, or in relation to, the trust. This is so, even if the representatives act beyond their actual authority. ***[Schedule 1, item 23, subsection 159-10(1)]***

2.40 In working out their personal tax liability, representatives do not take account of anything that they do, or that happens to them, in their capacity as representatives. ***[Schedule 1, item 23, section 159-15]***

2.41 There can be more than one representative of a trust (i.e. multiple trustees). Representatives are jointly and severally liable for the liabilities and obligations of a trust, including tax liabilities and obligations. ***[Schedule 1, item 23, subsection 159-10(3)]***

Chapter 3
Distributions by non-fixed trusts

Outline of Chapter

3.1 This Chapter explains what counts as a distribution from a non-fixed trust. It also explains what the amount of the distribution is and when it is to be taken into account.

3.2 The franking and imputation consequences of a distribution are explained in Chapter 7.

Context of reform

3.3 Under the current law, the amount of a non-fixed trust's net income to be included in a beneficiary's assessable income depends on the beneficiary's proportionate share of the net income and whether there is a present entitlement to such income.

3.4 Under the new regime, all benefits provided by a non-fixed trust which would be either dividends or deemed dividends if provided by a company, will be distributions. Thus, the rules which identify distributions and dividends will be broadly comparable. Some benefits specific to the non-fixed trust regime will also be distributions. The concepts of *net income* and *present entitlement* will no longer be relevant under the new regime.

3.5 The character of the income in the hands of the member will no longer be determined by the manner in which the trust earned it; rather, the character will depend on whether the distribution is sourced from either profits of the trust, contributed capital of the trust or a prior taxed amount. The tax treatment of the distribution then depends on its source. The source rules are discussed in Chapter 4 and the tax treatment of the distribution is discussed in Chapter 5.

3.6 The benefits flowing from tax preferred income will continue, though it will be the trust rather than the member which directly benefits from these preferences. The member, however, may still benefit indirectly by the recognition of the tax preferences at the trust level.

Summary of new law

3.7 Following is a summary of the new law in respect of distributions by non-fixed trusts.

What is a distribution?	Broadly, an amount paid or credited or the transfer of property to a current or former member, or an associate of either, by a non-fixed trust. Also, benefits provided by way of certain loans, debt forgiveness and excessive payments. There are also some special rules providing that certain amounts are taken to be distributions even if not directly provided by the non-fixed trust.
How much is the distribution?	The amount paid or credited or the value of property transferred.
When is a distribution paid?	Depending on the type of distribution, a distribution is paid either when provided or at the end of the non-fixed trust's year of income.

Comparison of key features of new law and current law

New law	***Current law***
Most amounts paid and credited to members, former members and associates will be distributions. Generally amounts paid or credited to associates will be taxed to the associate as distributions.	Beneficiaries are taxed on their share of the net income of the trust estate to which they are presently entitled. Distributions to entities which are not beneficiaries or beneficial objects are not covered.
Depending on the type of distribution members will be taxed either when they receive the distribution or at the end of the non-fixed trust's year of income.	Beneficiaries are taxed in the year of income in which the present entitlement arises.

Detailed explanation of new law

3.8 One of the cornerstones of the non-fixed trust regime is the bringing to account of most payments, loans and other credits by non-fixed trusts to members and associates. Such benefits are called distributions. The non-fixed trust regime also covers distributions to former members or their associates which are distributed because of that former membership.

3.9 Distributions occur where either the non-fixed trust makes the distribution directly or the non-fixed trust arranges for some other entity to make the distribution.

What is a distribution

3.10 There are essentially 3 types of distributions. These are:

- amounts that equate to 'dividends' as defined in subsection 6(1) and section 6BA of the ITAA 1936;
- payments made in respect of loans that a member or associate made to a non-fixed trust which formed part of the trust's contributed capital account; and
- other amounts that equate to deemed dividends made by companies.

3.11 These amounts can be grouped into 2 broad categories: distributions that can be franked and distributions which cannot be franked. Distributions falling into the former category are those outlined in the first dot point in paragraph 3.10. Distributions falling into the latter are those outlined in the second and third dot points.

Amounts equating to company dividends

3.12 Amounts that are ***distributions*** from non-fixed trusts are:

- money paid to members;
- amounts credited to members; and
- property transferred to members.

[Schedule 1, item 23, subsection 156-20(1)]

3.13 A non-fixed trust will not be taken to have credited an amount to a member merely because the member has become presently entitled to a trust amount ***[Schedule 1, item 23, subsection 156-20(2)]***. This ensures that present entitlement does not of itself give rise to a distribution.

3.14 This basic rule is comparable to the definition of 'dividend' in paragraphs 6(1)(a) and (b) of the ITAA 1936. It covers most provisions of value a non-fixed trust makes *to its current members*. Provisions to former members or to associates are not covered by this category of distribution. These are discussed in paragraphs 3.21 to 3.88.

What is the amount of a distribution?

3.15 The amount of the distribution will either be:

- if the benefit is a payment of money – the amount paid less any consideration (or market value of the consideration if the consideration is not in the form of money) provided to the non-fixed trust for the benefit ***[Schedule 1, item 23, paragraph 156-25(1)(a) and subsection 156-25(3)]***; or

- if the benefit is in a form other than money – the market value of what was provided less any consideration (or the market value of the consideration) provided to the non-fixed trust for the benefit ***[Schedule 1, item 23, paragraph 156-25(1)(b) and subsection 156-25(3)].***

3.16 Consideration that is in the form of:

- a surrender, cancellation or redemption of a membership interest; or

- a reduction in rights attaching to a membership interest,

is disregarded when determining the amount of consideration provided ***[Schedule 1, item 23, paragraph 156-25(2)(a)]***. This is to ensure that where a member surrenders or otherwise terminates their membership interest or rights it cannot be argued that by giving up the interest or rights the member has given consideration for the distribution received from the non-fixed trust to compensate for the termination.

3.17 Similarly, any consideration the member provides to acquire a membership interest or to obtain additional rights attaching to an existing membership interest is also disregarded. This is to ensure that when a member receives a distribution the amount of the distribution cannot be offset against the amount paid to gain the interest or right. ***[Schedule 1, item 23, paragraph 156-25(2)(b)]***

Payments in respect of certain loans

3.18 A loan repayment to a member or an associate in respect of a loan that has given rise to a contribution of capital will be treated as a distribution from a non-fixed trust to the recipient ***[Schedule 1, item 23, subsection 156-93(1)]***. Treating a repayment as a distribution is consistent with the treatment of a non-commercial loan as a contribution of capital which gives rise to a membership interest. As with other distributions, the repayment will be subject to the profits first rule except in certain, specified circumstances (discussed in paragraphs 4.6 to 4.24). The rules explaining when a loan will give rise to a contribution of capital are explained in Chapter 6.

3.19 A loan can only constitute contributed capital if, when the loan was made, the lender was either a current member or an associate of a current member. Thus, a repayment to a former member or their associate will only be a distribution if it is in respect of a loan the former member or associate made when the membership was current.

3.20 The repayment of a loan will only be treated as a distribution if the repayment is made after the time at which the contribution of capital is taken to have occurred ***[Schedule 1, item 23, paragraph 156-93(1)(c)]***. It does not matter whether the repayments are for capital or interest. When a repayment is made, the amount of the distribution is the amount of the repayment less any consideration provided to the trust for the payment ***[Schedule 1, item 23, subsection 156-93(2)]***. The making of the loan, or reducing the loan balance, is not consideration for the payment ***[Schedule 1, item 23, subsection 156-93(3)]***. This ensures that it cannot be argued that the original loan payment, or subsequent reduction of the amount owing, is consideration for the repayment.

Other amounts taken to be distributions

3.21 Other amounts, that had they been distributed by a company would have been deemed dividends, are distributions when made by a non-fixed trust. Distributions falling into this category include:

- certain amounts (called ‘distribution benefits’) and loans provided to members or former members (or associates);
- certain benefits or loans provided to members or former members (or associates) by an interposed entity;
- amounts or debts owed to a non-fixed trust by their members or former members (or associates) which the trust forgives;
- certain bonus interests issued in the trust; and
- excessive payments to members or former members (or associates).

3.22 The provisions which make these amounts distributions are closely modelled on section 6BA of Division 7A and section 109 of the ITAA 1936. These provisions ensure that the non-fixed trust regime identifies, as closely as possible, the same amounts as distributions that, had the distribution been made by a private company, would have been treated as a dividend. In this way, non-fixed trusts are prevented from disguising what would otherwise be a distribution of profits as a loan, excessive payments or some other type of benefit.

3.23 Explained below are the rules relating to:

- distribution benefits (paragraphs 3.24 to 3.28);
- loans (paragraphs 3.29 to 3.51);
- distribution benefits and loans which are not distributions (paragraphs 3.52 to 3.57);
- distribution benefits and loans made through an interposed entity (paragraphs 3.58 to 3.73);
- forgiveness of debts (paragraphs 3.74 to 3.88);
- excessive payments (paragraphs 3.89 to 3.91); and
- bonus issues (paragraphs 3.92 to 3.95).

Distribution benefits

3.24 The provision of a distribution benefit by a non-fixed trust to either:

- a member or their associate at the time the membership was current; or
- a former member or an associate[1] and a reasonable person would conclude the payment was made because of that former membership,

is treated as a distribution. ***[Schedule 1, item 23, subsection 156-75(1)]***

3.25 A non-fixed trust ***provides a distribution benefit*** to the extent that it:

- makes a payment to, on behalf of or for the benefit of a member, former member or associate;
- credits an amount to, on behalf of or for the benefit of a member, former member or associate; or
- transfers property to the member, former member or associate.

[Schedule 1, item 23, subsection 156-75(2)]

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[1] In this Chapter, whenever there is a reference to an 'associate', it includes a reference to:
- an associate of a current member;
- an associate of a former member; or
- a former associate of a current or former member.

3.26 Where the distribution benefit is provided by the non-fixed trust to a current member, it will generally be a distribution under the basic rule in section 156-20. It would therefore not be included in the member's assessable income again by reason of an exception discussed in paragraph 3.56. However, to the extent that the distribution benefit is not a distribution under the basic rule, it will be a deemed distribution under this rule.

3.27 Amounts which come within the definition of a 'loan' are not 'distribution benefits'. This is to ensure that distribution benefits and loans are mutually exclusive categories.

3.28 The amount of the distribution is the amount paid or credited ***[Schedule 1, item 23, subsection 156-75(3)]***. However, if the distribution benefit consists of a transfer of property then the amount of the distribution is the difference between the arm's-length value of the property and any consideration provided by the recipient of the distribution ***[Schedule 1, item 23, subsection 156-75(4)]***.

Loans

3.29 Generally, loans made by non-fixed trusts to their members, former members or associates will be treated as distributions where either:

- the loan is 'non-commercial'; or
- the loan is commercial but minimum payment requirements are not met.

There is also a distribution where a loan is made by another entity in certain circumstances. This is discussed in paragraphs 3.60 to 3.64. The rules are also subject to some exceptions discussed in paragraphs 3.52 to 3.57.

3.30 A ***loan*** includes:

- an advance of money;
- a provision of credit or any other form of financial accommodation;
- an amount paid for, on account of, on behalf of, or at the request of, a member or associate, if there is an express or implied obligation to repay the amount; and
- a transaction that in substance effects a loan of money.

[Schedule 7, item 49, definition of 'loan' in subsection 995-1(1)]

<u>Non-commercial loans</u>

3.31 A loan is treated as a distribution if a non-fixed trust makes a loan to either:

- a current member or their associate; or
- a former member or associate and a reasonable person would conclude the loan was made because of that former membership relationship,

and the loan is not fully repaid by the end of the non-fixed trust's year of income in which it is made. ***[Schedule 1, item 23, subsection 156-80(1)]***

3.32 However, a loan will not be treated as a distribution if it is a 'commercial loan' ***[Schedule 1, item 23, section 156-125]***. A ***commercial loan*** is a loan which is not a non-commercial loan ***[Schedule 7, item 12, definition of 'commercial loan' in subsection 960-180(3)]***. A loan is a ***non-commercial loan*** if:

- the loan is not made under a written agreement;
- the interest rate payable on the loan, for an income year after the year in which the loan is made, is less than the benchmark interest rate for the income year in which the loan is made; or
- the maximum term of the loan exceeds either:
  - 25 years for a loan secured over real property by a registered mortgage and, at the time the loan was first made, the property was valued for at least 110% of the loan amount;
  - 7 years for all other types of loans; or
  - if the regulations provide for working out the maximum term of the loan, the term worked out under the regulations.

[Schedule 7, item 1, subsection 960-180(1)]

3.33 The benchmark rate of interest is the bank variable housing loan interest rate last published by the Reserve Bank of Australia before the start of the year of income. ***[Schedule 7, item 1, section 960-185]***

3.34 The amount of the distribution is the amount of loan principal that has not been repaid ***[Schedule 1, item 23, subsection 156-80(2)]***. In calculating the amount of the loan that has not been repaid, certain payments are disregarded. This is explained in paragraphs 3.50 to 3.51. The distribution is taken to have been made at the end of the non-fixed trust's year of income in which the loan was made ***[Schedule 1, item 23, subsection 156-80(1)]***. For these purposes, a loan is made when either an amount is paid by way of loan or anything which falls within the definition of 'loan' is done ***[Schedule 1, item 23, subsection 156-80(4)]***.

Example 3.1

> The Dr Smith Trust Fund makes a non-interest bearing loan to Anne, a discretionary object, of $100,000. The loan is made on 1 March 2002. Anne makes no repayments before 30 June 2002. On 30 June 2002, the Dr Smith Trust Fund will be taken to have made a distribution of $100,000 to Anne.

3.35 As a general rule, existing loans from non-fixed trusts to members (and former members and associates) will not be affected. However, if the loan is in existence as at 1 July 2001 and it is varied either by extending the term or increasing its amount, then it is treated as a new loan which came into existence on the date of variation ***[Schedule 1, item 23, subsection 156-80(5)]***. The new regime may hence apply to such a loan.

<u>Commercial Loans</u>

3.36 A loan is not treated as a distribution at the end of the non-fixed trust's year of income if it is a 'commercial loan'. This ensures that genuine loans are not taxed unfairly. A loan is a ***commercial loan*** if it is not a 'non-commercial loan' (see paragraph 3.32). ***[Schedule 7, item 12, definition of 'commercial loan' in subsection 960-180(3)]***

3.37 Thus, a loan will be commercial if it is:

- under a written agreement;
- carries the required interest rate; and
- does not exceed the relevant maximum term.

3.38 The term 'commercial' has been used for convenience only. The definition will include loans as commercial for the purposes of the legislation even if they are not on fully commercial terms. The benchmark interest rate will ordinarily be below the interest that would be charged on a fully commercial loan.

<u>Amalgamated loans</u>

3.39 Commercial loans to members and former members (and associates) will not be treated as distributions even if the loan is not fully repaid at the end of the year in which it is made ***[Schedule 1, item 23, sections 156-125 and 156-135]***. However, one or more such loans which:

- have the same maximum term;
- are made during the same income year; and
- are not treated as distributions at the end of that year,

are brought together to form a single amalgamated loan (i.e. loans secured over real property will be amalgamated together and other loans will be amalgamated together). If, in subsequent years, the recipient of the loan fails to meet the 'minimum yearly repayment' requirements in respect of the amalgamated loan then the amount of the amalgamated loan that remains unpaid will be a distribution ***[Schedule 1, item 23, subsections 156-85(1) and (2)]***.

What are the minimum yearly repayment requirements

3.40 There are no minimum yearly repayment requirements for the income year in which the commercial loan is made. In the second and subsequent years there must be a minimum repayment for each member's 'amalgamated loan'. An ***amalgamated loan*** comprises all 'commercial loans' (the 'constituent loans') that:

- would have been treated as distributions had they been 'non-commercial';
- have the same 'maximum term' (see paragraph 3.32); and
- are not fully repaid at the end of the income year in which they were made (certain repayments are disregarded when calculating the amount that remains unpaid – see paragraphs 3.50 to 3.51).

[Schedule 1, item 23, subsection 156-86(1)]

3.41 A single commercial loan may be an amalgamated loan if it is the only loan that meets the criteria for an income year. The amount of the amalgamated loan is the total of the amounts of the constituent loans which have not been repaid at the end of the income year in which the amalgamated loan was made. ***[Schedule 1, item 23, subsection 156-86(1)]***

3.42 To work out what is the minimum yearly repayment that should be made for an amalgamated loan, all amounts of the constituent loans that are unpaid before the start of the non-fixed trust's income year are added up.

3.43 The benchmark interest rate for the year in which the repayment is being calculated must then be ascertained. This is the rate discussed in paragraph 3.33 and is effectively the secured home loan interest rate. The remaining term of the loan, in effect the remaining period of the loan, must then be worked out. This is done by taking the number of years of the longest term of any of the constituent loans that form the amalgamated loan. That number is reduced by the number of years between the end of the income year in which the loan is taken to be made and the end of the income year prior to the one for which the minimum repayment is being worked out – in effect, the expired part of the period of the loan. It is rounded up to the nearest whole number if the difference is not a whole number. ***[Schedule 1, item 23, subsection 156-86(4)]***

3.44 The minimum yearly repayment is then worked out using the formula:

$$\frac{\text{amount of loan remaining unpaid by the end of the previous income year} \times \text{current year's benchmark interest rate}}{1 - \left[\dfrac{1}{1 + \text{Benchmark interest rate}}\right]^{n}}$$

[Schedule 1, item 23, subsections 156-86(3) and (4)]

3.45 The denominator in the formula is an adjustment factor based on repaying the amalgamated loan over the remaining period of the loan. ***[Schedule 1, item 23, subsection 156-86(4)]***

3.46 If the repayment made is less than the amount worked out, the minimum repayment requirements on the amalgamated loan are taken not to have been met and a distribution is taken to have been made on the last day of the non-fixed trust's income year ***[Schedule 1, item 23, subsection 156-85(1)]***. The amount of the distribution is the balance of the amalgamated loan that has not been repaid at the end of the non-fixed trust's income year ***[Schedule 1, item 23, subsection 156-85(2)]***. For these purposes, any payment made in relation to a constituent loan is treated as a payment toward the amalgamated loan which includes the constituent loan ***[Schedule 1, item 23, subsection 156-86(2)]***.

Example 3.2

The Hookanya Trust made 2 commercial loans to Simone during the year ending 30 June 2002. Simone is an associate of Brett, a current member. The first loan is for $100,000 and is secured over future income. Its term is 6 years. The second loan is for $50,000 and is unsecured. Its term is 4 years. Both loans are made under written agreements and the benchmark interest rate is charged. As at 30 June 2002, Simone had only repaid $5,000. During the year ending 30 June 2003, Simone repays $28,000.

As the loans are commercial, the Hookanya Trust is not taken to make a distribution at the end of the year in which the loans were made. Whether they amount to distributions in the 2003 income year depends on whether the repayment made by Simone satisfies the minimum yearly repayment requirements for the 2003 income year. As neither of the loans are secured over real property, they have the same maximum term and are hence added together to form an amalgamated loan.

Step 1: Work out the amount that has not been repaid.

The total sum of the loans is $150,000. As only $5,000 has been repaid, the amount that remains unpaid is $145,000.

Step 2: Work out the benchmark interest rate.

For the 2003 year, assume the benchmark interest rate is 8.5%.

Step 3: Work out the remaining term of the loan.

The longest term of any of the constituent loans is 6 years. As the minimum yearly repayment requirement is being worked out for the 2003 income year (the income year following that in which the loan was made), the 6 years is not reduced. The remaining term is therefore 6 years.

Step 4: Work out the minimum yearly repayment.

$$\frac{145{,}000 \times 0.085}{1 - \left[\frac{1}{1 + 0.085}\right]^{6}}$$

$$= \quad 145{,}000 \times 0.085$$

$$= \quad 0.3870549$$

$$= \quad \$31{,}843$$

As the amount that Simone repaid is less than the minimum yearly repayment requirement, $117,000 will be treated as a distribution to Simone on 30 June 2003.

<u>What happens if the minimum yearly repayment would cause hardship?</u>

3.47 The Commissioner may determine that a distribution is not made, notwithstanding that the borrower has not met the minimum repayment requirements, if the borrower satisfies the Commissioner that this is due to circumstances beyond their control and they would suffer undue hardship if the unpaid amount was treated as a distribution. ***[Schedule 1, item 23, subsection 156-140(1)]***

3.48 In determining whether the amalgamated loan should be treated as a distribution the Commissioner must consider the following:

- the capacity of the borrower, at the end of the income year to repay the loan;
- any circumstances which may have reduced the borrower's capacity to repay the loan;
- whether the borrower has taken all reasonable steps to make the minimum yearly repayments for the income year; and

- whether the borrower has made up the shortfall in repayments of the loan as soon as possible after the end of the income year.

[Schedule 1, item 23, subsection 156-140(2)]

3.49 An example of where the Commissioner may exercise his or her discretion is where the member or associate has been involuntarily retrenched from their employment and hence can no longer meet the required loan repayments.

What loan repayments can be taken into account?

3.50 In working out whether the loan is fully repaid for the purposes of determining what amount is treated as a distribution and whether the minimum yearly repayment requirements have been met, certain payments are disregarded. ***[Schedule 7, item 1, subsection 960-190(1)]***

3.51 A payment is disregarded (and not taken into account in working out how much of a loan remains unpaid) if a reasonable person would conclude (having regard to all the circumstances) that, at the time of the payment, the borrower intended to obtain another loan from the lender of a similar or larger amount than the payment ***[Schedule 7, item 1, subsection 960-190(2)]***. However, this rule does not apply if the payment is:

- by way of a set off of a distribution payable by the lender to the borrower or salary or wages payable by the lender to the borrower where the distribution or the salary or wage is offset against an amount payable on the loan ***[Schedule 7, item 1, paragraph 960-190(3)(a)]***;

- a payment made by another party on behalf of the borrower that is assessable income of the borrower in the income year in which the payment was made (e.g. because it is income of the borrower which the borrower has directed be paid directly to the lender) or an earlier income year (e.g. because it accrued to the borrower in that earlier year but has not actually been paid by the third party) ***[Schedule 7, item 1, paragraph 960-190(3)(b)]***; and

- an amount for property the borrower has transferred to the lender where the payment is offset against an amount payable on the loan. The amount that can be taken into account is an amount that does not exceed the difference between what a party would have paid in an arm's-length dealing for the property and any amount that the lender has already paid to the borrower for the transfer ***[Schedule 7, item 1, subsection 960-190(4)]***.

Loans and distribution benefits which are not distributions

3.52 Certain distribution benefits and loans will not be treated as distributions. Two exclusions have already been discussed in paragraphs 3.36 and 3.47. These are:

- commercial loans in the year in which they are made (though these may be treated as a distribution in subsequent years if the minimum yearly repayment requirements are not met); and

- amalgamated loans in respect of which the minimum yearly repayment requirements have not been met and the Commissioner exercises his discretion to determine that the amalgamated loan should not be treated as a distribution.

<u>A distribution benefit made to discharge a pecuniary obligation</u>

3.53 If a non-fixed trust provides a distribution benefit in order to discharge a pecuniary obligation owed by the non-fixed trust to a member or former member (or associate), the distribution benefit will not be treated as a distribution. However, it is only excluded from being a distribution to the extent to which the amount of the distribution benefit is not more than the amount that would have been paid had the non-fixed trust and recipient been dealing with each other at arm's-length. This ensures that commercial dealings are not unfairly taxed and that, for example, disguised distributions are not made by inflating the amount of a debt owed to a member or associate by a non-fixed trust. ***[Schedule 1, item 23, subsection 156-105(1)]***

3.54 However, where the distribution benefit constitutes a repayment of a non-commercial loan that gave rise to a contribution of capital, this exception does not apply to such a repayment and it is still a distribution under the rules discussed in paragraphs 3.18 to 3.20. ***[Schedule 1, item 23, subsection 156-105(2)]***

<u>Certain distribution benefits and loans to other non-fixed trusts and companies</u>

3.55 A distribution benefit or loan a non-fixed trust makes to either another non-fixed trust or a company (other than where the recipient is acting in the capacity of trustee) is not treated as a distribution ***[Schedule 1, item 23, section 156-110]***. However, if the recipient then provides a distribution benefit or loans an amount to a member of the first non-fixed trust it may constitute a distribution from the first non-fixed trust under the interposed entity rules. These are discussed further in paragraphs 3.58 to 3.73.

<u>Distribution benefits and loans that are otherwise assessable</u>

3.56 To the extent to which the distribution benefit or loan by the non-fixed trust to a member or former member (or associate) is included in that recipient's assessable income under some other provision of the income tax laws, the distribution benefit or loan is not treated as a distribution ***[Schedule 1, item 23, subsection 156-115(1)]***. For example, if the distribution benefit is a distribution under the basic rule (discussed in paragraph 3.12) then it will not also be a distribution under these rules. Also, a distribution benefit or loan is not treated as a distribution to the extent to which it is specifically excluded from the assessable income of the recipient by some other provision of the income tax laws. ***[Schedule 1, item 23, subsection 156-115(2)]***

Loans made in the ordinary course of business

3.57 A loan is not treated as a distribution if it is made in the ordinary course of the non-fixed trust's business and on the usual terms on which the trust makes similar loans to parties at arm's-length. ***[Schedule 1, item 23, section 156-120]***

Distribution benefits and loans through interposed entities

3.58 Special rules are needed to deal with distribution benefits and loans made through interposed entities. Without such rules, it would be possible for a non-fixed trust to avoid the application of the distribution rules by arranging for another entity to provide the distribution benefit or make the loan to a member (or former member or associate) on its behalf. For example, a non-fixed trust could arrange for another entity to make a loan to a member of the non-fixed trust and pay consideration to that entity for providing this service. As the payment or loan has not been made directly by the non-fixed trust then, under the general rules, a distribution has not been made by the non-fixed trust to that member.

3.59 The rules regarding interposed entities will therefore apply where there are back-to-back arrangements under which a non-fixed trust provides a distribution benefit or loans an amount to an interposed entity on the understanding that the interposed entity (or another interposed entity) will provide a distribution benefit or loan an amount (though not necessarily the same amount) to a member or former member (or associate). In these circumstances, the non-fixed trust is treated as having made the distribution benefit or loan directly and will be treated as having made a distribution. The source of the distribution (and hence how it is taxed) will be calculated based on the accounts of the non-fixed trust.

Distribution benefits and loans

3.60 A distribution benefit (see paragraph 3.25) or loan will be treated as having been provided by the non-fixed trust if:

- the non-fixed trust provides a distribution benefit or makes a loan to an entity interposed (the 'interposed entity') between the non-fixed trust and the member (or former member or associate);

- a reasonable person would conclude that the distribution benefit was provided or loan was made either solely or mainly as part of an arrangement to provide a distribution benefit or make a loan to a member (or former member or associate) of the non-fixed trust; and

- the interposed entity, which received the distribution benefit or loan, or another interposed entity provides a distribution benefit or makes a loan to the member (or former member or associate).

[Schedule 1, item 23, subsection 156-165(1)]

3.61 It is irrelevant whether the non-fixed trust provided the distribution benefit or loan to the interposed entity before or after the distribution benefit was provided or loan was made to the member (or former member or associate). It is also irrelevant whether the amount of the distribution benefit or amount loaned by the non-fixed trust was the same amount that was provided by the interposed entity. ***[Schedule 1, item 23, subsection 156-165(2)]***

3.62 However, if the distribution benefit or loan to the interposed entity is itself a distribution elsewhere under the non-fixed trust rules, then any distribution benefit provided or loan made by the interposed entity will not be treated as a distribution by the non-fixed trust. Thus, if the interposed entity is a member of the non-fixed trust, then a payment to it by the non-fixed trust may be a distribution. The interposed entity will hence be taxed on it. If the interposed entity then pays or loans that same amount to another member of the non-fixed trust as part of a relevant arrangement, the non-fixed trust will not be treated as having made a distribution for a second time. ***[Schedule 1, item 23, paragraph 156-165(1)(d)]***

<u>Distribution benefits and loans relying on guarantees</u>

3.63 A non-fixed trust is treated as having provided a distribution benefit if:

- the non-fixed trust guarantees a loan made by an interposed entity;

- a reasonable person would conclude that the non-fixed trust gave the guarantee solely or mainly as part of an arrangement to provide a distribution benefit or make a loan to a member (or former member or associate) of the non-fixed trust; and

- either:

  – the interposed entity which is another non-fixed trust or a private company makes a loan to that member or associate; or

– another interposed entity which is another non-fixed trust or a private company, provides a distribution benefit or makes a loan to that member or associate.

[Schedule 1, item 23, subsections 156-170(1) and (2)]

3.64 It does not matter whether the interposed entity provided the distribution benefit or made the loan before, after or at the same time as it received the guarantee from the non-fixed trust. It is also irrelevant whether the amount of the distribution benefit or amount loaned by the interposed entity is the same amount as the non-fixed trust guaranteed. ***[Schedule 1, item 23, subsection 156-170(3)]***

Certain liabilities under guarantees treated as distribution benefits

3.65 A non-fixed trust is also taken to make a distribution benefit if:

- the non-fixed trust guarantees a loan that an entity makes to a member (or former member) of the non-fixed trust; and
- as a result of the guarantee the non-fixed trust has a present liability to make a payment to that entity.

[Schedule 1, item 23, subsection 156-175(1)]

3.66 The usual circumstances in which this provision will apply is where the borrower has defaulted under the loan agreement and the non-fixed trust, as guarantor, becomes liable to pay the lender as a result. However, if an amount has already been treated as a distribution because of section 156-170 (distribution benefits and loans through interposed entities relying on guarantees), and the loan guaranteed under that section is the same loan that the borrower defaulted on, then the amount of the distribution arising because the non-fixed trust becomes liable to pay on the guarantee, is reduced by the amount already treated as a distribution ***[Schedule 1, item 23, subsection 156-175(2)]***. This provision does not require an arrangement before it will apply. However, the Commissioner may determine that a distribution is not made if the Commissioner is satisfied that the borrower, who had the capacity to repay the loan when it was entered into, would suffer undue hardship if the amount was treated as a distribution ***[Schedule 1, item 23, subsection 156-175(3)]***.

Example 3.3

Kia, a discretionary object of the Roy Family Trust, requires $100,000 to invest in her business. The Roy Family Trust does not distribute the money directly to Kia. Instead, it arranges for Al Co, an unrelated private company, to make a low interest bearing loan to Kia. The Roy Family Trust then guarantees the loan. The Roy Family Trust will be treated as having made a payment to Kia. The Commissioner determines the amount of the distribution to be $100,000.

> After 10 months, Kia defaults on the loan. The outstanding balance is $105,000 (including interest which is capitalised). The Roy Family Trust becomes liable to pay Al Co $105,000. As $100,000 has already been treated as a distribution, only $5,000 would be treated as a distribution.

<u>Amount and timing of distribution benefit provided via an interposed entity</u>

3.67 Where the interposed entity rules treat the non-fixed trust as having provided a distribution benefit directly to one of its members (or former members or associates), the amount of the distribution benefit will be determined by the Commissioner. In making this determination the Commissioner must consider:

- the amount of the distribution benefit the interposed entity provided to the recipient; and
- any amount of the distribution benefit that represents arm's-length consideration payable for anything.

[Schedule 1, item 23, subsection 156-180(2)]

3.68 The non-fixed trust is taken to provide the distribution benefit when the interposed entity provided the distribution benefit. ***[Schedule 1, item 23, subsection 156-180(1)]***

<u>Amount and timing of loan through an interposed entity</u>

3.69 If the non-fixed trust is taken to make a loan (called the 'notional loan') under the interposed entity rules, the amount of the notional loan will be determined by the Commissioner ***[Schedule 1, item 23, subsection 156-185(1)]***. In making this determination the Commissioner must consider:

- the amount the interposed entity loaned to the recipient; and
- any amount of the payment that represents arm's-length consideration payable for anything.

[Schedule 1, item 23, subsection 156-185(2)]

3.70 In determining the amount of the notional loan, and hence the amount of the distribution, any repayments made by the member to the non-fixed trust are taken into account. Repayments of the notional loan are calculated as a proportion of the total loan repayment made to the interposed entity which is referable to the notional loan. ***[Schedule 1, item 23, subsection 156-185(3)]***

Example 3.4

The Mor Trust lends $100 to Keg and Chubbs Partnership. The Keg and Chubbs Partnership lends $150 to Akim, a discretionary object of the Mor Trust. The loans were part of an arrangement to make a loan to Akim. The Commissioner concludes that the amount of the notional loan is $100. Akim repays $21 to the Keg and Chubbs Partnership. The notional repayment is:

$$\text{Repayment made by Akim} \times \frac{\text{Amount of notional loan}}{\text{Amount actually lent to Akim}}$$

$$= \$21 \times \frac{\$100}{\$150}$$

$$= \$14$$

3.71 Even if the loan is exempt under another section (because it is made in the ordinary course of business and on usual terms – see paragraph 3.57 – or it is a commercial loan), it may still be taken into account in determining the amount of the notional loan made by the non-fixed trust. ***[Schedule 1, item 23, subsection 156-190(2)]***

3.72 The non-fixed trust is taken to provide the loan when the interposed entity made the loan to the member. ***[Schedule 1, item 23, subsection 156-185(1)]***

3.73 A non-fixed trust may still be taken to make a distribution even if the distribution benefit or loan to the interposed entity would satisfy the exceptions relating to:

- distribution benefits or loans to other non-fixed trust and companies;
- distribution benefits or loans that are otherwise assessable;
- commercial loans; or
- loans made in the ordinary course of business.

[Schedule 1, item 23, section 156-190]

Forgiven debts

3.74 A non-fixed trust is taken to make a distribution when it forgives a debt owed by either:

- a member or their associate; or
- a former member or associate where a reasonable person would conclude that the debt was forgiven because of that former membership relationship.

[Schedule 1, item 23, subsection 156-90(1)]

3.75 The amount of the distribution is the amount that has been forgiven ***[Schedule 1, item 23, subsection 156-90(2)]***. The distribution is taken to be paid at the end of the non-fixed trust's year of income in which the debt was forgiven.

3.76 However, if the debt is a loan which has already been treated as a distribution (whether as a non-commercial loan or as a constituent loan included in an amalgamated loan) a later forgiveness will not give rise to a distribution. This prevents loans being taxed twice. ***[Schedule 1, item 23, subsection 156-100(2)]***

3.77 If the amount of a constituent loan has been forgiven then the same amount is taken to be forgiven in relation to the amalgamated loan for the purposes of working out the amount of the amalgamated loan. This ensures amounts taxed as distribution under the forgiveness provisions are not taxed again under the provisions relating to amalgamated loans. ***[Schedule 1, item 23, subsection 156-90(3)]***

<u>What is debt forgiveness?</u>

3.78 Basically, a debt (including a loan), or part of a debt, is taken to be forgiven if the debtor's obligation to pay the debt, or part of the debt, is released, waived or is otherwise extinguished ***[Schedule 7, item 1, subsection 960-195(2)]***. Interest payable on a loan is not a separate debt but is part of the debt if it remains outstanding. It is important to note that a part of a debt may be forgiven. The provisions will then apply to that part and not the whole of the debt.

3.79 A debt will also be taken to be forgiven if any of the following occurs:

- a creditor loses its right to sue the debtor for the recovery of a debt due to the operation of a statute of limitations. The debt will be treated as forgiven at the time the right to sue is lost ***[Schedule 7, item 1, subsection 960-195(3)]***; or

- a debtor is effectively released from the obligation to pay the debt notwithstanding the existence of arrangements which imply that the debt remains on foot. Under some arrangements, the debtor's obligation to pay the debt may not cease immediately but at some future time. Nevertheless, the debt will be treated as forgiven immediately if the debtor's obligation is to terminate at that future time without the debtor incurring any further cost or other obligations being imposed (other than what is purely a nominal or insignificant amount or kind taking the debtor's circumstances into account) ***[Schedule 7, item 1, subsection 960-195(4)]***. A debt which is treated as forgiven because of such an arrangement will not be subject to the debt forgiveness provisions again when the debt is actually forgiven. If the provisions did apply when the later, actual forgiveness occurs, it would result in double taxation.

Example 3.5

Dina is a discretionary object of Sac Trust. Dina owes Sac $100,000. Sac agrees to release Dina from this debt if Dina makes an immediate payment of $1,000 and an additional payment of $1 each year for the next 5 years. The debt will exist until the last $1 payment has been made at which time Dina will be released from any further obligations in respect of the debt.

The $1 payment would be viewed as a purely nominal amount and the debt will be treated as forgiven upon payment of the $1,000. The amount taken to be forgiven would be $99,000.

3.80 A debt is also taken to be forgiven if a reasonable person would conclude, taking all relevant circumstances into account, that the non-fixed trust will not insist on being repaid or that it does not rely on the debt being repaid. The debt (or part of it) will be taken to be forgiven at the time the reasonable person would conclude that the non-fixed trust will not insist on being paid or at the time it no longer relies on being paid. The amount of the debt forgiven is the amount that a reasonable person would conclude would not be collected by the non-fixed trust. ***[Schedule 7, item 1, subsection 960-195(7)]***

3.81 A debt will also be forgiven if a creditor of the non-fixed trust contributes capital to the non-fixed trust so to enable the non-fixed trust to make a payment toward the debt (in whole or in part) and the non-fixed trust so applies that capital. The debt is forgiven when the capital is applied toward the debt and the amount that is taken to be forgiven is the amount that was so applied. ***[Schedule 7, item 1, subsection 960-195(6)]***

<u>Debt parking</u>

3.82 In relation to some debts, the creditor may assign its rights (or part of its rights) under a debt to a third party (the assignee) without the debtor’s obligations under the debt being forgiven. It is possible for the debtor to be effectively released from its debt if, because of a relationship between the debtor and the assignee, the assignee would not seek to recover the debt. When this ‘debt parking’ type of arrangement occurs, the debt forgiveness provisions will apply as if the debt had been forgiven instead of being assigned where:

- the assignee is an associate of the debtor; or
- the assignment occurred under an arrangement to which the assignee and the debtor were parties; and

- a reasonable person would conclude (having regard to all the circumstances) that the assignee will not seek to exercise their right to the debt.

3.83 The debt (or part of the debt) will be taken to be forgiven at the time the assignment is made. The amount of the debt that will be taken to be forgiven is the amount to be paid by the debtor under the creditor's right that has been assigned; that is, the amount of the debt (or that part of the debt) assigned. ***[Schedule 7, item 1, subsection 960-195(5)]***

Example 3.6

> Using the facts from Example 3.5, if Sac assigned the entire debt to Desmond, Dina's son, then the debt would be taken to be forgiven at the time of that assignment. Because Dina and Desmond are mother and son (and are hence associates) it is reasonable to assume that Desmond would not insist on repayment. The amount of the debt taken to be forgiven, would be $100,000.

<u>When is a debt not taken to have been forgiven</u>

3.84 If a debtor becomes a bankrupt or a deed of arrangement is entered into under Part X of the *Bankruptcy Act 1966* and the debt is terminated, that will not, by itself, constitute forgiveness of the debt for the purposes of the non-fixed trust regime. Furthermore, if a debt is discharged by the transfer of property to the creditor, that will not, of itself, constitute forgiveness of the debt. ***[Schedule 7, item 1, subsection 960-195(8)]***

3.85 The debt can only be taken to be forgiven once. Thus, if the debt is taken to be forgiven at an earlier time and the forgiveness is actually effected at a later time, then the later forgiveness will not be treated as a distribution. ***[Schedule 7, item 1, subsection 960-195(9)]***

Example 3.7

> Thus, in Example 3.5, the debt was taken to be forgiven when Dina made the $1,000 repayment. If, at a later date, SAC formally forgives the debt, this later forgiveness will not be treated as a distribution.

3.86 The forgiveness of a debt which arises out of a loan by the non-fixed trust that was treated as a distribution (either because it was a non-commercial loan or an amalgamated loan in respect of which the minimum yearly repayments were not met) will not give rise to a distribution. ***[Schedule 1, item 23, subsection 156-100(2)]***

3.87 If the debt is owed to the non-fixed trust by another non-fixed trust or by a company then any amount forgiven will not give rise to a distribution (unless the debt was owed in the capacity of trustee). ***[Schedule 1, item 23, subsection 156-100(1)]***

3.88 Finally, a non-fixed trust will not be taken to make a distribution because it has forgiven a debt if the Commissioner is satisfied that:

- the debt was forgiven because payment of the debt would have caused the debtor undue hardship;
- when the debtor first incurred the debt, the debtor had the capacity to repay the debt; and
- the debtor lost the ability to repay the debt in the foreseeable future as a result of circumstances beyond their control.

[Schedule 1, item 23, subsection 156-100(3)]

Excessive Payments

3.89 Certain other amounts to members, former members or associates that purport to be connected with employment may also constitute distributions. This is to ensure that a non-fixed trust cannot avoid the distribution rules by inflating amounts payable to members (or their associates) in connection with their employment.

3.90 Thus, an amount will be a distribution where:

- a distribution benefit is provided to a member, former member or associate of any of them;
- the amount is purportedly either:
  - remuneration for services rendered by the recipient; or
  - paid in connection with the retirement from, or termination of, an office or employment from the non-fixed trust; and
- the amount is excessive in the opinion of the Commissioner.

3.91 Only the excessive amount (i.e. the amount over and above what the Commissioner believes to be reasonably payable) will be treated as a distribution. This amount will then be a distribution subject to the profits first rule and the non-fixed trust will not be entitled to a deduction for this amount. ***[Schedule 1, item 23, section 156-92]***

Bonus Issues

3.92 A non-fixed trust also makes a distribution if:

- a current member who holds an interest is given a choice between being paid a distribution or receiving bonus interests in respect of the original interests held; and
- the member chooses to receive bonus interests.

[Schedule 1, item 23, subsection 156-94(1)]

3.93 The amount of the distribution is the amount that would have been paid had the member chosen to receive a distribution instead of bonus interests ***[Schedule 1, item 23, subsection 156-94(2)]***. The source of this distribution then depends on the application of the profits first rule (discussed in Chapter 4). The source in turn determines how much is included in the member's assessable income. If the distribution is from profits, it will be included in the member's assessable income. If it is from contributed capital then it is dealt with under the CGT provisions. If the distribution is from profits, an amount equal to the distribution will be credited to the non-fixed trusts contributed capital account ***[Schedule 1, item 23, subsection 156-94(3)]***.

3.94 The consideration the member is taken to have paid for the bonus interests depends on whether the distribution is taken to be funded out of profits and whether the distribution is rebatable. If the distribution is taken to be funded from profits the consideration the taxpayer is taken to have provided for acquiring the bonus interests is so much of the distribution that is included in the taxpayer's assessable income and is not rebatable (under the new imputation provisions). ***[Schedule 1, item 23, section 158-10]***

3.95 In the case where the distribution is funded out of profits but is rebatable, or where the distribution is funded out of contributed capital, the amount the member is taken to have paid for the original interests and the bonus interests is calculated in such proportions that the Commissioner considers appropriate. Generally, this means that the member must spread the cost of the original interests over both the original interests and the bonus interests in a reasonable manner. ***[Schedule 1, item 23, section 158-15]***

Example 3.8

Duff Trust has 100 unit holders and 100 discretionary objects. To its unit holders, Duff Trust offers a choice of:

- a $100 cash payment; or
- 5 bonus units.

Wallace, an individual, chooses to receive the bonus units. As a result, Duff Trust is taken to have made a distribution to Wallace of $100. Assuming Duff Trust has sufficient profits (see Chapter 4), the $100 will be taken to be sourced from profits and will be included in Wallace's assessable income (see Chapter 5). If the distribution is unfranked Wallace will be taken to have paid $100 consideration for the 5 bonus units.

Distributions disregarded for certain purposes

3.96 Distributions under Subdivision 156C to 156E are disregarded for the purposes of:

- non-resident withholding tax;

- collection and withholding; and
- PAYG withholding.

The non-fixed trust is therefore not required to withhold any amount from the distribution. ***[Schedule 1, item 23, section 156-200]***

<u>Distribution used to offset an earlier distribution</u>

3.97 Generally, if a distribution (the 'later distribution') is used to offset an amount that has already been treated as a distribution (the 'earlier distribution'), the portion of the later distribution used to offset the earlier distribution will not be taxed. ***[Schedule 1, item 23, subsections 156-210(1) and (2)]***

3.98 If the later distribution is frankable then it is still considered a distribution to the extent that it is franked. This ensures that the franking credit is available to the member and can be applied against other income tax liabilities. ***[Schedule 1, item 23, subsection 156-210(2)]***

Example 3.9

> A Trust is a non-fixed trust. It loans $100 to B Trust on the understanding that B Trust will loan an amount to Jay, a member of A Trust. The loan will be treated as a distribution made by A Trust.
>
> At a later date, A Trust decides to make a partly franked distribution to Jay of $110. The franked portion of the distribution is $70 (i.e. $30 franking credits are attached) and the unfranked portion is $40. Instead of paying the distribution directly to Jay, A Trust pays it to B Trust in repayment of the loan. The $40 unfranked portion is offset against the loan and will not be treated as a distribution. However, the $70 franked portion will still be treated as a distribution so that Jay will still be able to benefit from the $30 of franking credits attached to the distribution.

<u>Franking Credits</u>

3.99 A distribution benefit or loan that is taken to be a distribution under Subdivisions 156-C to 156-E cannot be franked (other than bonus interest issues that are taken to be distributions out of profits under section 156-94). The recipient is therefore not entitled to a franking credit to offset their income.

3.100 In order to prevent unfranked distributions being streamed to certain members, the imputation laws will be amended so that a non-fixed trust will be required to make a debit to its franking account when it is taken to have paid the distribution to the member or associate. The rules for achieving this are explained in Chapter 7.

Amount treated as distribution is not a fringe benefit

3.101 The non-fixed trust regime will apply to a loan or forgiven debt even if the amount is provided or lent to the member or the member's associate in their capacity as an employee or an associate of an employee of the non-fixed trust ***[Schedule 1, item 23, subsections 156-205(1) and (2)]***. Double taxation will be avoided by providing that amounts, taken to be a distribution under the non-fixed trust regime, will be excluded from the definition of 'fringe benefits' contained in the FBTAA 1986. Thus, a non fixed trust will not be subject to FBT on an amount taxed to a member or associate. A consequential amendment will give effect to this rule.

3.102 The non-fixed trust rules will not apply to the provision of a distribution benefit if it is made to the member or associate in their capacity as an employee or associate of an employee. The definition of 'employee' is that which applies for the purposes of the FBTAA 1986. The effect of this provision is that the provision of a distribution benefit (including the transfer of property, such as mobile phones and laptop computers) to a member (or their associate) in their capacity as an employee will be subject to the provisions of the FBTAA 1986 and not the non-fixed trust rules. ***[Schedule 1, item 23, subsection 156-205(3)]***

Consequential amendments

3.103 There are no consequential amendments.

Chapter 4
Source of distributions

Outline of Chapter

4.1 This Chapter explains how to determine how much of each distribution is from profits, contributed capital or prior taxed amounts. The source of the distribution determines how it is taxed in the hands of the member.

Context of reform

4.2 The non-fixed trust regime allows deferral of member level taxation on profits retained by the non-fixed trust. The profits first rule stops this deferral continuing after distribution by treating distributions as out of profits to the extent that the trust has profits available while the member's interest in the trust is retained. The profits first rule is the default rule for determining the source of distributions.

4.3 Deferral of tax is not a concern for a distribution made in connection with the cancellation of a member's interest. A member who gives up their interest is not postponing member level taxation of gains, as no further gains from the interest are to be expected. Apportioning, under the slice rule approach, a distribution into components of contributed capital and taxed and untaxed profit allows the member to be taxed appropriately. The share of contributed capital attributable to the cancelled interest will be the first component of the distribution, followed by the share of taxed (and so fully franked) profits attributable to the cancelled interest. The balance of the distribution will be untaxed (and so unfranked) profits. There are other, more limited, specific exceptions to the profits first rule.

Summary of new law

What the Division will do?	Division 157 explains how to determine the source of a distribution from a non-fixed trust.
What are the possible sources of a distribution?	Distributions can be wholly or partly from profits, from contributed capital or of prior taxed amounts.
What is the general source rule?	A distribution is from profits to the extent the non-fixed trust has available profits (including unrealised gains) and any balance is from contributed capital. Once contributed capital is exhausted, any prior taxed amounts must be distributed, and then all further distributions are from (unfrankable) profits. This is the profits first rule.
What exceptions are there to the profits first rule?	Primarily, distributions connected with the cancellation of a membership interest, and also in certain cases for distributions of prior taxed amounts.

Detailed explanation of new law

4.4 The tax treatment of a distribution at the member level depends on whether it is sourced from a non-fixed trust's profits, contributed capital or prior taxed amounts (see Chapter 5). Its source will also determine whether the distribution is franked. Only distributions sourced from available profits or from taxed profits are frankable. The primary rule for determining source is the profits first rule.

4.5 In this context, reference to a distribution being from a particular source is a reference to the distribution to the extent to which it is from that source (i.e. from profits, from contributed capital, or of prior taxed amounts). So a distribution will be from a particular source to the extent that it is from that source, even if it is also from another source. ***[Schedule 1, item 23, section 154-60]***

Profits first rule

What is the profits first rule?

4.6 A distribution will be taken to be from available profits to the extent that a non-fixed trust has available profits immediately before the distribution is made ***[Schedule 1, item 23, paragraph 157-20(a)]***. This is the ***profits first rule*** and it is the default rule for determining the source of any distribution. It applies unless there is a specific exception ***[Schedule 1, item 23, subsection 157-10(3)]***. In general, while members hold their membership interest they share in the ongoing profits of the non-fixed trust. Thus, distributions are taken to come from profits while the non-fixed trust has profits, as the value of the continuing membership interests continues to exceed the contributed capital of the trust, and so as a matter of substance no contributed capital is being returned by the distributions.

4.7 Where the distribution exceeds the amount of available profits, the excess is taken to be from the trust's contributed capital ***[Schedule 1, item 23, paragraph 157-20(b)]***. Prior taxed amounts are not included in available profits. The profits first rule does not, therefore, apply to distributions of prior taxed amounts and such amounts can be retained or distributed by the non-fixed trust. However, if a distribution exceeds both available profits and contributed capital, it must be from prior taxed amounts ***[Schedule 1, item 23, paragraph 157-40(2)(b)]***. If the non-fixed trust does not have any prior taxed amounts then such a distribution is taken to be from anticipated profits ***[Schedule 1, item 23, paragraph 157-20(c)]***. To the extent to which the distribution is from anticipated profits, it is not frankable ***[Schedule 1, item 23, subsection 160-32(2)]***.

What are available profits?

4.8 Basically, available profits are the *net market value of the trust's assets* less certain accounting provisions, contributed capital and prior taxed amounts. ***[Schedule 1, item 23, subsection 157-85(1)]***

What is the net market value of the trust's assets?

4.9 The net market value of the non-fixed trust's assets is the market value of its assets less the amount of its present liabilities ***[Schedule 1, item 23, subsection 157-85(1)]***. Available profits therefore capture all accumulated profits, whether realised or unrealised, and whether taxable at the trust level or not. These net gains should be captured, as they need to be taken into account in working out whether the remaining value of the trust after a distribution is enough to match the contributed capital of the trust.

4.10 Certain assets and liabilities are disregarded in calculating the net market value of assets ***[Schedule 1, item 23, subsection 157-85(4)]***. Including them in the formula would produce a distorted view of available profits. When calculating the net market value of the non-fixed trust the following assets are to be disregarded:

- a right that the non-fixed trust has to a contribution of capital, as this is not yet included in the contributed capital account and so would overstate available profits; and

- any rights the non-fixed trust has under a loan to a member that was a distribution, as this asset has already been dealt with as being distributed to members.

[Schedule 1, item 23, subsection 157-85(4), item 1 in the table]

4.11 The following liabilities are also to be disregarded:

- an obligation the non-fixed trust has to make a distribution, as this obligation is not yet accounted for as a distribution (e.g. if a non-fixed trust has exercised a discretion to make a distribution but has not yet set a payment date or paid or credited it to the members, this would not be treated as a liability when working out the net market value of the non-fixed trust's assets);

- any obligations the non-fixed trust has under a loan from a member that is treated as a contribution of capital to the trust, as those obligations are only obligations to make what will be a distribution when made; and

- any liabilities that are not present, legal obligations. Thus, contingent liabilities and other liabilities that have not yet crystallised are not taken into account when calculating the market value of the trust's assets. However, certain accounting provisions are taken into account.

[Schedule 1, item 23, subsection 157-85(4), item 2 in the table]

Reduction for accounting provisions

4.12 The following provisions (as shown in the trust's accounting records) are subtracted from the net market value of the trust's assets:

- provision for depreciation;

- provision for annual leave and long service leave;

- provision for the amortisation of intellectual property and trademarks; and

- any other provision that may be prescribed by regulation.

[Schedule 1, item 23, subsection 157-85(1)]

Reduction for contributed capital

4.13 The net market value of a non-fixed trust's assets is reduced by the total amount of the trust's contributed capital. Contributed capital is explained in more detail in Chapter 6. It is basically whatever has been contributed to the trust for, or to add value to, a membership interest in the non-fixed trust. It includes amounts settled to establish the trust and subsequent settlements. Certain other amounts (mainly as part of transitional arrangements for trusts existing at commencement of the non-fixed trust regime or when the non-fixed trust regime commences to apply to the trust) are also credited to the contributed capital account.

4.14 Where a non-fixed trust's contributed capital would otherwise be less than nil (which may occur, for instance, as a result of the transitional measures) it is taken to be nil in applying profits first (and slice) rules. Otherwise available profits under the profits first rule could be increased, perhaps beyond the net value of the assets of the trust, and untaxed profits under the slice rule could be increased, perhaps beyond the total consideration for the redemption or cancellation of a membership interest. ***[Schedule 1, item 23, section 157-190]***

4.15 Once available profits have been exhausted, the effect of the profits first rule is that further distributions are from (and reduce) contributed capital. The profits first rule does not limit distributions of contributed capital to the share of contributed capital that relates to the membership interests in respect of which the distributions are made. So the contributed capital account and sub-accounts have to be adjusted for distributions of contributed capital that may exceed the particular interests' share of contributed capital, under rules discussed in Chapter 6.

What are the non-fixed trust's prior taxed amounts?

4.16 Prior taxed amounts (explained in more detail in Chapter 5) are amounts retained by the trust that have borne tax under the rules relating to trusts before the trust became subject to the non-fixed trust regime. Without a deduction of such prior taxed amounts, available profits would be overstated, and distributions of prior taxed amounts would not be excepted from the profits first rule.

Reliance on accounting records

4.17 Non-fixed trusts may rely on their accounting records and statements to determine that a distribution is wholly from available profits. Thus, if their accounting records show that the non-fixed trust has profits the trust is taken to have sufficient profits to cover the distribution. This would mean that a fresh valuation of the non-fixed trust's assets and liabilities is not required before making each distribution. The provision is intended to reduce the compliance cost. For most ongoing non-fixed trusts, it will usually be the case that the use of accounting records would treat a distribution as coming entirely from profits, and this would be the most convenient treatment for the trust and its members. Where this treatment is not appropriate, the non-fixed trust can choose to apply the formula strictly, ordinarily because this will show the distribution to be in part from contributed capital. ***[Schedule 1, item 23, subsection 157-85(2)]***

4.18 However, if the Commissioner considers that the accounting records show the trust's assets to be significantly undervalued, or its liabilities significantly overvalued, then the Commissioner may substitute an appropriate value ***[Schedule 1, item 23, subsection 157-85(3)]***. This ensures that the non-fixed trust can only rely on its accounting records when they represent a true reflection of its economic situation.

Dealing with multiple distributions

4.19 Where distributions subject to the profits first rule are made to more than one entity at the same time, and the total of those distributions exceeds the non-fixed trust's available profits at that time, each distribution will contain available profits in proportion to the non-fixed trust's available profits as a share of the total amount distributed at that time ***[Schedule 1, item 23, subsection 157-25(1)]***. Likewise, where the total distributions which would be taken to be from contributed capital are made to more than one entity, and the total of those distributions exceed contributed capital, each distribution will contain contributed capital in proportion to the non-fixed trust's contributed capital as a share of the total of all the amounts distributed at the same time ***[Schedule 1, item 23, subsection 157-25(2)]***. At the *same time* may, as discussed in paragraphs 4.21 to 4.24, include all payments within a 5 day period.

Example 4.1: Multiple distributions

> Distributions (subject to the profits first rule) of $10 each are made to 2 members of a non-fixed trust at the same time.
>
> Available profits of the trust immediately before the distributions are $16. Each member would be taken to receive $8 of profits and $2 of contributed capital.

4.20 This provision provides for equal treatment between members, and limits profits being streamed to some members and contributed capital to others, in the same way as the 5 day rule.

Distributions made at the same time (the 5 day rule)

4.21 A grouping rule applies to avoid the compliance costs that could arise from having to determine available profits successively many times when a large number of distributions are made under the same decision to distribute or within a short period of time ***[Schedule 1, item 23, subsection 157-240(2)]***. This rule also limits the ability of non-fixed trusts to distribute available profits to one entity and contributed capital to another by using up available profits for the first distribution leaving only contributed capital for the second ***[Schedule 1, item 23, subsection 157-240(1)]***. All distributions made within the same 5 business day period and under the same decision of the non-fixed trust are taken, for certain purposes, to be made at the time the first of those distributions are made ***[Schedule 1, item 23, subsection 157-245(1)]***.

4.22 Distributions, even made pursuant to a single decision of the trust, that are spread over a period of greater than 5 business days, will need to be grouped into periods of 5 business days, with distributions in each period taken to be made at the time of the first distribution in that period. No day can form part of more than one such period; that is, such periods cannot overlap. ***[Schedule 1, item 23, subsection 157-245(3)]***

4.23 Available profits must be recalculated for each period, immediately prior to the first distribution of that period ***[Schedule 1, item 23, paragraph 157-245(1)(c)]***. Distributions made in each period will be *multiple distributions*, ensuring that for each period, each distribution will contain a proportionate component of available profits ***[Schedule 1, item 23, paragraph 157-245(1)(d)]***. Where the distributions are from contributed capital, the contributed capital account is reduced for all distributions when the first distribution is made. The contributed capital component of all the distributions is then calculated on the same basis ***[Schedule 1, item 23, subsection 157-245(2)]***.

4.24 The rule is not needed in relation to a succession of distributions subject only to slice rule calculations, as the proportion of contributed capital and taxed profits in distributions to which those rules apply is not reduced as each slice distribution is made. However, the rule will apply to a succession of distributions any of which is subject to the default 'profits first' rule, as such distributions may affect the share of contributed capital and of taxed profits that relate to particular membership interests. General anti-avoidance rules may apply to arrangements where, for instance, separate decisions or staggered distributions are arranged to avoid or manipulate the effect of the 5 day rule.

Example 4.2: Distributions made over a period of time

> Several distributions are made between 1 June and 5 June under the same decision made by the non-fixed trust. The distributions are treated as a single distribution and available profits are calculated immediately prior to the distribution on 1 June. If available profits are insufficient, each of the distributions will have the same proportionate amount of profits and contributed capital.
>
> On 9 June, a further distribution is made pursuant to the same decision as before. The trust cannot treat the 9 June distribution as falling in the same 5 day period as the 5 June distribution. A new calculation of available profits must be done for the distribution. That calculation will be made on the basis of the position of the trust after all the 1 June to 5 June distributions.

What exceptions are there to the profits first rule

4.25 There are 3 exceptions to the profits first rule:

- the slice rule;
- prior taxed amounts; and
- certain realised proceeds of trusts.

The latter 2 exceptions are discussed later in this Chapter.

The slice rule

What is the slice rule?

4.26 For distributions related to the cancellation or termination (whether formal or informal) of a membership interest or the proportional reduction of all the rights attaching to a membership interest in a non-fixed trust, their source is generally taken to be first from that membership interest's share of contributed capital, then from that membership interest's share of taxed profits, and then from untaxed profits ***[Schedule 1, item 23, section 157-215 and subsection 157-220(2)]***. This is the ***slice rule***. The slice rule is expressed as an exception to the profits first rule to ensure that the 2 rules cover all distributions to the extent they are not from prior taxed amounts or from certain concessionally taxed gains realised by trusts ***[Schedule 1, item 23, section 157-45 and subsection 157-220(1)]***.

4.27 The slice rule recognises the circumstances in which non-fixed trusts return contributed capital along with taxed and untaxed profits even though contributed capital and profits remain in the trust, in a manner which is fair as between members, while placing a limit on dividend substitution and capital streaming opportunities. ***[Schedule 1, item 23, section 157-215]***

When does the slice rule apply?

4.28 The slice rule recognises that, where a membership interest is really given up, it gives no further right to distributions. Hence, the slice rule applies when a membership interest ceases to exist. In that case, the first thing the member gets back should be taken to be the slice of contributed capital referable to the interest given up.

4.29 Once that share of contributed capital has been returned, the next thing the member gets back should be the slice of taxed profits (fully franked) referable to the interest given up. If the member gets more than that, the rest of what the member gets must be untaxed (and unfrankable) profits.

4.30 The slice rule applies to each membership interest, because separate membership interests may be separately cancelled or redeemed. This reflects the concept of membership interest (discussed in Chapter 2) so that it is not possible to cancel only some of the membership interests held by a member and yet calculate slice according to the whole of the contributed capital and taxed profits referable to all the membership interests held by the member. ***[Schedule 7, item 1, section 960-125]***

4.31 However, if the distribution consists of a prior taxed amount, then the slice rule does not apply to the distribution to the extent it is of a prior taxed amount. This ensures that prior taxed amounts to a member who is a tax-recipient remain non-assessable irrespective of the circumstances in which they are distributed. ***[Schedule 1, item 23, subsections 157-45(1) and (3)]***

4.32 There are separate rules applying to fixed interests and non-fixed interests.

Fixed membership interests

4.33 The slice rule will apply where the distribution results directly in a fixed membership interest ceasing to exist (other than in a proportionate rearrangement) and market value consideration is given for the interest.

<u>When fixed membership interests (or rights) cease to exist</u>

4.34 The slice rule will apply when the distribution results directly in a fixed membership interest ceasing to exist ***[Schedule 1, item 23, subparagraph 157-45(1)(a)(i)]***. A fixed membership interest may cease to exist by being cancelled or redeemed, by an obligation being satisfied, by the trust ceasing to exist, or otherwise: this recognises cases where the cancellation or redemption of the membership interest is carried out both as part of some larger action, such as the vesting of a trust, and also where there is a cancellation of one membership interest only ***[Schedule 1, item 23, subparagraph 157-45(1)(a)(i)]***. The membership interest which ceases to exist is the membership interest in relation to the distribution ***[Schedule 1, item 23, paragraph 157-45(2)(a)]***.

4.35 Examples of where fixed membership interests cease to exist include:

- cancellation of a unit in the unitised class of a hybrid trust; or
- the vesting of all the assets of the trust.

4.36 The slice rule also applies to a distribution that results directly in the proportional rights attaching to a membership interest being reduced. ***[Schedule 1, item 23, subparagraph 157-45(1)(a)(ii)]***

4.37 For example, where a beneficiary has a fixed interest in 10% of the income and capital in a non-unitised class of a hybrid trust, and that interest is reduced to 5% in return for a market value distribution, the distribution will be subject to the slice rule. In such cases the relevant share of the membership interest is treated as a separate, cancelled interest. That membership interest is then the membership interest in relation to the distribution. ***[Schedule 1, item 23, paragraph 157-45(2)(b)]***

4.38 The slice rule does not apply to a distribution made by way of a proportionate rearrangement of membership interests ***[Schedule 1, item 23, paragraph 157-45(1)(b)]***. This would be the case where, for example, a quarter of each members' interests are cancelled and members receive a distribution as part of the arrangement. In that case no membership interest is really given up; after the proportional reduction, the members continue to own the trust in the same proportions as before, so whatever distribution each member has had leaves them with a share of the trust as before ***[Schedule 7, item 1, sections 960-130 and 960-135]***. The profits first rule is therefore the correct rule for determining the source of these distributions.

<u>Market Value consideration</u>

4.39 The slice rule does not further apply if the consideration paid for the membership interest in relation to the distribution is less than market value. This situation is dealt with under the profits first rule ***[Schedule 1, item 23, paragraph 157-45(1)(c)]***. The slice rule cannot apply, because where the distribution is for less than market value the apparent cancellation or redemption can lead to preferential treatment of remaining membership interests, lending itself to tax-based arrangements and inconsistent tax treatment overall.

Non-fixed membership interests

4.40 The profits first rule will not (and hence the slice rule will) apply to a distribution to a member in respect of a non-fixed entitlement where the distribution is made as part of a process in which the non-fixed interest ceases to exist because the trust terminates. Thus, a member can only apply the slice rule to a distribution received in respect of a non-fixed membership interest where the distribution is made because the entire trust is terminating. The profits first rule will apply to all other distributions. ***[Schedule 1, item 23, subsection 157-45(3)]***

Series of distributions under a single decision

4.41 To reduce the number of times where the components of the slice of a non-fixed trust need to be calculated, a special rule applies. The rule provides that where a series of distributions is made in relation to membership interests of a particular class and each one in the series is subject to the slice rule, the contributed capital, taxed profit and untaxed profit components of each subsequent distribution will be the same as those calculated for the first distribution ***[Schedule 1, item 23, subsection 157-220(3)]*** until one of the following events occurs:

- the franking account balance changes for a reason unrelated to earlier distributions in the series (e.g. because of the receipt of a franked dividend) ***[Schedule 1, item 23, paragraph 157-220(3)(d)]***;
- the relevant contributed capital sub-account balance changes for a reason unrelated to earlier distributions in the series (e.g. because of the settlement of additional assets on a non-fixed trust) ***[Schedule 1, item 23, paragraph 157-220(3)(e)]***; or
- there is a change in the amount of the distributions to be made in the series (keeping total distributions to a single overall

amount maintains the consistency of the taxed profits and contributed capital amounts required to be part of the series) ***[Schedule 1, item 23, paragraph 157-220(3)(f)]***.

4.42 In calculating the taxed profit component of a slice of a non-fixed trust, the market value of its assets enters into the calculations (because available profits are a limit on what would otherwise be the total taxed profits shared between membership interests). The single decision rule will remove the formal need to recalculate the taxed and untaxed profit components as market values change.

Calculating the slice components

4.43 The slice rule apportions a distribution into components of contributed capital and profit relevant to the membership interest that ceases to exist, or otherwise terminates, or a proportion of the rights which have reduced ***[Schedule 1, item 23, subsection 157-220(2)]***. Where a relevant distribution contains a prior taxed amount, the slice rule applies to the amount of the distribution less the prior taxed amount. In effect, any payment of a prior taxed amount is a separate distribution to the one to which the slice rule applies.

4.44 The slice components are determined in a series of steps. The membership interest's share of contributed capital is worked out first. If equal to or greater than the distribution, the whole distribution is contributed capital. If less than the distribution, the remainder of the distribution is from profit. The taxed profit component is then worked out, and the excess remaining above the slice of taxed profit, if any, is untaxed profit. No prior taxed amounts are shared out under the slice rule, for 2 reasons. First, some prior taxed amounts may not have related exclusively to any particular membership interests. For example, a share of net income may have been taxed because no member was presently entitled to it, and in that case there may be many tax-free recipients between whom the prior taxed amounts could be distributed. Second, the termination of other membership interests does not ordinarily change the capacity of a member or former member to demand a prior taxed amount to which they were presently entitled, or to be considered for distribution of a prior taxed amount to which no member was presently entitled. So the slice rule cannot properly share out prior taxed amounts. ***[Schedule 1, item 23, subsection 157-220(2)]***

What is the interest's share of contributed capital?

4.45 The calculation depends on how many classes of membership interest the trust has and on the particular interest's share relative to other interests of the same class ***[Schedule 1, item 23, section 157-225]***. For this purpose, membership interests are of the same class if they each carry the same rights to distributions by the trust, even if they have different rights in some other respects ***[Schedule 7, item 11, definition of 'class' in subsection 995-1(1)]***.

4.46 The first step is to establish the amount of contributed capital attributable to the class to which the interest belongs:

- where the non-fixed trust has just one class of membership interests, the contributed capital attributable to the class is the balance of the non-fixed trust's contributed capital account ***[Schedule 1, item 23, subsections 157-195(1) and 157-225(1)]***;

- where the non-fixed trust has more than one class of interests, the contributed capital attributable to a particular class will be the balance of the contributed capital sub-account for that class ***[Schedule 1, item 23, subsection 157-225(1)]***. Contributed capital sub-accounts are discussed in more detail in Chapter 6; or

- where the balance of the account would otherwise be less than nil, it is taken to be nil ***[Schedule 1, item 23, paragraph 157-190(b)]***.

4.47 The second step is to establish the interest's share of the contributed capital account or sub-account relative to other interests within its class ***[Schedule 1, item 23, subsection 157-225(2)]***. The calculation of the share depends on whether the interests in the class are:

- unitised, that is, divided into units which have equal entitlements with each other and so divide entitlements according to the number of such units (e.g. a unit in the unitised class of a hybrid trust):
  - in this case, each single interest shares the contributed capital of the class equally, in proportion to the number of such interests in the class;

- fixed but not unitised (e.g. a fixed, non-unitised interest in a hybrid trust):
  - in this case, each separate interest takes its fixed interest regardless of other interests in the class and so shares the contributed capital of all such interests in proportion to its share of all interests actually existing; or

- non-fixed and non-unitised:
  - in this case, each separate interest shares the contributed capital in proportion to its share of the distribution, as such an interest can be cancelled only when the whole trust terminates. If only some members of the class receive distributions, then the contributed capital of the class is shared out among them proportionately. (Note that non-fixed membership interests are taken to cease to exist in such circumstances) ***[Schedule 1, item 23, subsection 157-45(3)]***.

[Schedule 1, item 23, subsection 157-225(3)]

4.48 The proportional share is called the 'contributed capital factor for the membership interest'. In the case of a unitised, or fixed interest, the proportion is simply established (as set out in paragraph 4.46). However, with non-fixed interests, the only objective method of establishing the factor is by comparing the distribution to a particular interest with distributions to other interests in the class (noting that the slice rule can only apply to non-fixed interests when an entire class terminates). ***[Schedule 1, item 23, subsection 157-45(3)]***

4.49 Applying the contributed capital factor (proportional share) to the balance of the relevant contributed capital sub-account determines the interest's share of contributed capital.

Example 4.3: Calculation of contributed capital component

Item	***Circumstances of the membership interest***	***Balance of contributed capital sub-account***	***Contributed capital factor of membership interest***	***Interest's share of contributed capital***
1	A member has one share of 100 units in the class.	$200	1/100	$2
2	A member has fixed rights to 20% of the income and capital of a hybrid trust.	$200	1/5	$40
3	Termination of a wholly non-fixed trust – distribution for interest $125; total distribution $1,000.	$400	1/8	$50

Working out the taxed profit component of a distribution

4.50 The *taxed profit* component of a distribution is treated as a fully franked profit distribution, representing the interest's share of the non-fixed trust's taxed profits ***[Schedule 1, item 23, subsection 157-230(1)]***. The calculation of the taxed profit component differs from that of contributed capital as taxed profits are not differentially allocated between classes compared to untaxed profits. In effect, franking credits are treated as being equally available for all of a non-fixed trust's profits distributed under the slice rule.

4.51 The non-fixed trust's franking account balance immediately before the distribution is made is a convenient and objective measure of its taxed profits.

4.52 The interest's share of the franking account balance is based on the member's notional share of available profits. This share, as a proportion, is called the 'taxed profit factor for the membership interest'. ***[Schedule 1, item 23, subsection 157-230(2)]***

4.53 With contributed capital, where interests in the class are unitised or fixed, an interest's position relative to other interests in its class is generally clear. However, because a non-fixed trust's taxed profit is not attributed to particular classes of interests differently to the attribution of profit as a whole, applying a simple proportionate approach for these types of interests can only be done where the non-fixed trust has just one class of membership interests, all of which are fixed. This is not possible for a non-fixed trust (otherwise it will be a fixed trust). Instead, the taxed profit factor is calculated by taking that part of a distribution in relation to a membership interest that is not a return of contributed capital and spreading taxed profits according to the proportion that part bears to available profits. ***[Schedule 1, item 23, subsection 157-230(2)]***

Example 4.4: Calculation of taxed profit factor

> A non-fixed trust terminates. The taxed profit factor is the distribution less the interest's share of contributed capital, divided by the available profits. Available profits, for this purpose, can only be calculated via the formula approach in the profits first rule if the contributed capital component is greater than zero (as accounting records would be unable to show that the entire distribution is wholly from profits).

Working out the untaxed profit component of a distribution

4.54 The untaxed profit component of a distribution is the balance of the distribution: the amount, if any, that is neither contributed capital nor taxed profit. ***[Schedule 1, item 23, subsection 157-220(2)]***

Example 4.5: Applying the slice rule where membership interests are non-fixed

> XYZ Trust has 10 members all of whom hold non-fixed entitlements. On 30 June 2003, the XYZ Trust completely vests under the terms of its trust deed. The total of the distributions equals $100,000. Dee receives $10,000. Just prior to the distribution, the balance of XYZ Trust's contributed capital account is $60,000. The balance of the franking account is $6,000 (on a tax paid basis) and it has available profits of $20,000. As the trust has terminated, the slice rule applies to calculate the source of the distribution received by Dee.

Calculations

Step 1: Work out the interest's share of contributed capital (see subsection 157-225(2)).

(a) interest's share of contributed capital

$$= \text{balance of contributed capital sub-account for class} \times \text{contributed capital factor for the membership interest}$$

(b) contributed capital factor where membership interests are neither unitised nor fixed (see subsection 157-225(3), item 3 in the table)

$$= \frac{\text{Distribution in relation to the membership interest}}{\text{Distribution in relation to all membership interests in the class}}$$

$$= \frac{10{,}000}{100{,}000}$$

$$= 0.10$$

(c) interest's share of contributed capital

$$= 60{,}000 \times 0.10$$

$$= 6{,}000$$

Step 2: Work out whether the distribution is wholly from contributed capital.

In this example, the distribution is $10,000 and the interest's share of contributed capital is $6,000 per unit. Therefore the distribution is *not* wholly from contributed capital.

Step 3: If the distribution is greater than the interest's share of contributed capital, the distribution is:

- from contributed capital to the extent of the interest's share of contributed capital; and
- from profits to the extent of the excess of the distribution over the interest's share of contributed capital.

Therefore, the distribution per unit is made up of $6,000 from contributed capital and $4,000 from profits.

Step 4: As the distribution is to some extent from profits, the taxed profit component of the distribution must be worked out.

$$\begin{array}{c}\text{non-fixed trust's}\\ \text{franking surplus}\\ \text{immediately}\\ \text{before the}\\ \text{distribution is made}\end{array} \times \frac{1 - \text{franking rate}}{\text{franking rate}} \times \begin{array}{c}\text{taxed profit}\\ \text{factor for the}\\ \text{membership interest}\end{array}$$

(a) grossed up franking amount

$$= \text{franking account balance} \times \frac{1 - \text{franking rate}}{\text{franking tax rate}}$$

$$= 6{,}000 \times \frac{1 - 0.3}{0.3}$$

$$= 14{,}000$$

(b) taxed profit factor is:

$$\frac{\begin{array}{c}\text{Distribution in relation}\\ \text{to membership interest}\end{array} - \begin{array}{c}\text{interest's share of}\\ \text{contributed capital}\end{array}}{\text{available profits}}$$

$$= \frac{10{,}000 - 6{,}000}{20{,}000}$$

$$= 0.2$$

(c) taxed profit component

$$= 14{,}000 \times 0.2$$

$$= \$2{,}800$$

Step 5: Work out whether the balance of the distribution is wholly from taxed profits.

In this example, the distribution from available profits per unit is $4,000 as calculated in step 3. The taxed profit component per unit is $2,800. Therefore the distribution from available profits is *not* wholly from taxed profits.

Step 6: If the distribution from available profits is greater than the taxed profit component, the distribution is:

- from taxed profits to the extent of the taxed profit component; and

- from untaxed profits to the extent of the excess of the distribution from available profits over the taxed profit component.

Therefore, the distribution from taxed profits is \$2,800 and the balance of \$1,200 is from untaxed profits.

Therefore, the slice components of Dee's distribution is:

Contributed capital:	\$6,000
Taxed profits:	\$2,800
Untaxed profits:	\$1,200
Total distribution:	\$10,000

Example 4.6: Applying the slice rule where membership interests are unitised

ABC Trust is a hybrid trust. It has 2 classes of membership interests: non-fixed entitlements and 20,000 units. On 30 June 2003, the trust cancels some of its units. It makes a distribution of \$90,000 in respect of 10,000 of its units in relation to that cancellation (i.e. \$9 is distributed in respect of each of the 10,000 units). Just prior to the distribution the balance of the trust's contributed capital account is \$100,000. The balance of the sub-account for the unitised class is \$50,000. The balance of the trust's franking account is \$6,000 and available profits are \$130,000. As the interests have been cancelled, the slice rule applies.

Calculations

Step 1: Work out the interest's share of contributed capital (see subsection 157-225(2).

(a) interest's share of contributed capital

$$= \text{Balance of contributed capital sub-account for class} \times \text{contributed capital factor for the membership interest}$$

(b) contributed capital factor where membership interests are unitised (see subsection 157-225(3), item 1 in the table)

$$= \frac{1}{\text{Number of membership interests in the class}}$$

$$= \frac{1}{20{,}000}$$

(c) interest's share of contributed capital

$$= 50{,}000 \times \frac{1}{20{,}000}$$

$$= \$2.50 \text{ per unit}$$

Step 2: Work out whether the distribution is wholly from contributed capital.

In this example, the distribution is $9 for each relevant unit and the interest's share of contributed capital is $2.50 per unit. Therefore the distribution is *not* wholly from contributed capital.

Step 3: If the distribution is greater than the interest's share of contributed capital, the distribution is:

- from contributed capital to the extent of the interest's share of contributed capital; and
- from profits to the extent of the excess of the distribution over the interest's share of contributed capital.

Therefore, the distribution per unit is made up of $2.50 from contributed capital and $6.50 from profits.

Step 4: As the distribution is to some extent from profits, the taxed profit component of the distribution must be worked out.

$$\text{non-fixed trust's franking surplus immediately before the distribution is made} \times \frac{1 - \text{franking rate}}{\text{franking rate}} \times \text{taxed profit factor for the membership interest}$$

(a) grossed up franking amount

$$= \text{franking account balance} \times \frac{1 - \text{franking rate}}{\text{franking tax rate}}$$

$$= 6{,}000 \times \frac{1 - 0.3}{0.3}$$

$$= 14{,}000$$

(b) taxed profit factor is:

$$\frac{\text{Distribution in relation to membership interest} - \text{interest's share of contributed capital}}{\text{available profits}}$$

$$= \frac{9 - 2.5}{130{,}000}$$

$$= 0.00005$$

(c) taxed profit component

$$= 14{,}000 \times 0.00005$$

$$= \$0.70 \text{ per unit}$$

Step 5: Work out whether the balance of the distribution is wholly from taxed profits.

In this example, the distribution from available profits per unit is $6.50 as calculated in step 3. The taxed profit component per unit is $0.70. Therefore, the distribution from available profits is *not* wholly from taxed profits.

Step 6: If the distribution from available profits is greater than the taxed profit component, the distribution is:

- from taxed profits to the extent of the taxed profit component; and
- from untaxed profits to the extent of the excess of the distribution from available profits over the taxed profit component.

Therefore, the distribution from taxed profits is $0.70 per unit and the balance of $5.80 per unit is from untaxed profits.

Therefore, the slice components of the distribution per unit is:

Contributed capital:	$2.50
Taxed profits:	$0.70
Untaxed profits:	$5.80
Total distribution:	$9.00

Terry is a unit holder of ABC Trust and he owns 500 of the 10,000 units that were involved in the cancellation. His share of the distribution is therefore made up of the following components.

Contributed capital:	500	×	$2.50	=	$1,250
Taxed profits:	500	×	$0.70	=	$350
Untaxed profits:	500	×	$5.80	=	$2,900
Total distribution:					$4,500

Other exceptions to the profits first rule

4.55 There are 2 other exceptions to the profits first rule, other than the slice rule. The other exceptions relate to distributions from prior taxed amounts and certain realised proceeds.

Exception for prior taxed amounts

4.56 The profits first rule does not apply to a distribution from prior taxed amounts ***[Schedule 1, item 23, section 157-40]***, reflecting the fact that they have already been fully taxed. A distribution from this source can be made regardless of whether the trust has available profits from which the distribution could otherwise be made ***[Schedule 1, item 23, subsection 157-40(1)]***.

4.57 To provide for certainty in interpreting the legislation, it is made clear that under the profits first rule a non-fixed trust can make a distribution of contributed capital even if it still has prior taxed amounts, and that where available profits and contributed capital are exhausted, a distribution to which the profits first rules applies must necessarily be from prior taxed amounts ***[Schedule 1, item 23, subsection 157-40(2)]***. For the reasons discussed in paragraph 4.43, so far as the slice rule applies, no prior taxed amounts are being distributed. Prior taxed amounts are discussed in greater detail in Chapter 5.

Exception for certain realised proceeds of trusts

4.58 This exception is intended to maintain the effect of current CGT treatment of gains on realisation of assets held in a trust at the announcement of the CGT changes. Such amounts would be credited to the non-fixed trust's contributed capital account on realisation and would include capital gains realised on pre-CGT assets, the discount capital gain, the indexation component and the small business 50% active assets reduction component of capital gains.

4.59 Without an exception from the profits first rule, these gains would be added to contributed capital but could not then be distributed until all available profits were distributed, although previously they would have been able to be distributed directly. Consistent with the commitment in ANTS, to the extent to which the distribution is from such an amount, the profits first rule does not apply and the distribution is taken to be wholly from contributed capital provided that the distribution is made within 12 months following the end of the year in which the asset is realised. (This is more generous than the rule proposed in *A Tax System Redesigned*). ***[Schedule 1, item 23, subsections 157-55(1) and (2)]***

4.60 The resultant reduction to the non-fixed trust's contributed capital account is taken into account when determining the other components of the distribution and the components of other distributions made on the same day and of subsequent distributions under subsection 157-220(3) and distributions under Subdivision 157-E. ***[Schedule 1, item 23, subsection 157-55(3)]***

Chapter 5
Taxing distributions from non-fixed trusts

Outline of Chapter

5.1 This Chapter explains how distributions from a non-fixed trust are taxed in the hands of the member.

5.2 The rules are contained in Division 154 and cover distributions of profits, distributions of contributed capital and distributions of prior taxed amounts.

5.3 Imputation credits, for tax already paid by the entity, are dealt with in Chapter 7.

Context of reform

5.4 The non-fixed trust regime characterises distributions as being made up of distributions from profits, from contributed capital, or from prior taxed amounts. These rules are dealt with in Chapter 4. In this context, general rules prescribe the tax effect for members of distributions so far as they are from profits, from contributed capital, or from prior taxed amounts.

Summary of new law

5.5 Division 154 sets out the tax effect of a distribution from a non-fixed trust. The rules are summarised here.

How are distributions treated?	This depends on the extent to which they are sourced from a non-fixed trust's profits, contributed capital or prior taxed amounts.
Distribution from profits.	Is included in assessable income.
Distribution from contributed capital.	Generally reduces the cost base of the membership interest to which it relates, and is treated as a capital gain to the extent it exceeds that value.
	Distributions of contributed capital made by a family trust to members with a non-fixed membership interest will not generally be assessable if the members are part of the same family group as the trust.

Distribution from prior taxed amounts.	Not assessable to members in relation to whom the prior tax was payable. If to other members, included in assessable income.

Comparison of key features of new law and current law

New law	***Current law***
Members, former members and their associates will include in their assessable income distributions made to them to the extent they are out of profits.	Beneficiaries include in assessable income their share of the net income of the trust estate to which they are presently entitled.
Generally, distributions of contributed capital to members will reduce the cost base of the membership interest. Distributions of contributed capital from a family trust to members with a non-fixed membership interest will not generally be taxed if those members are part of the same family group as the family trust.	Distributions of amounts that have not been included in the net income of a trust reduce the cost base of a beneficiary's interest. An interest of a discretionary object is not of the kind to which the CGT cost base reduction rules apply.

Detailed explanation of new law

5.6 A distribution from a non-fixed trust to a member (or former member or associate) of the trust may be taken into account in working out the recipient's taxable income or may affect their tax position in other ways. Its treatment depends on the extent to which it is sourced from the distributing trust's profits, contributed capital or prior taxed amounts.

5.7 A distribution from the trust's profits will be included in the assessable income of the recipient. A distribution from contributed capital is generally only included in assessable income to the extent it exceeds the cost base of the membership interest to which it relates. Distributions of previously taxed amounts to certain members are not assessable; to other members they are included in assessable income.

What is meant by source of the distribution?

5.8 A reference to the distribution being from a particular source is a reference to the distribution to the extent it is from that source (e.g. profits, contributed capital and prior taxed amounts). This rule allows for clearer drafting while recognising that a single distribution may be from more than one source. Therefore, for example, a reference to a distribution from profits is a reference to the distribution to the extent it is from profits, even if it is also in part from contributed capital. ***[Schedule 1, item 23, section 154-60]***

5.9 The provisions contained in Division 157 determine the source from which the distribution by a non-fixed trust is made. These provisions are discussed in Chapter 4.

What is the cost base of an interest?

5.10 Each membership interest has a cost base. The cost base of the membership interest is its cost base for CGT purposes. The cost base is an element in calculation of capital gains or losses and in calculation of depreciation recapture; no special provision for calculating gains or losses on disposal is required.

Distribution of profits

5.11 A distribution from a non-fixed trust's profits is included in the assessable income of the recipient. ***[Schedule 1, item 23, section 154-5]***

5.12 A distribution will generally be taken to have been made from profits if profits are available and only from contributed capital when available profits are exhausted (this is the 'profits first rule' and it is discussed in Chapter 4). The recipient will be allowed a (generally refundable) credit for any tax already paid by the non-fixed trust, that attaches to the distribution.

5.13 Where the profits first rule applies, and there are no available profits or contributed capital, any further distributions are taken to be out of profits and are unfrankable. Where the slice rule discussed in Chapter 4 applies, distributions out of profits are either from the membership interest's share of taxed profits, and fully franked, or from untaxed profits, and unfranked. The franking and imputation rules are dealt with in Chapter 7.

Distribution of contributed capital

5.14 Distributions of contributed capital will be dealt with under the CGT provisions ***[Schedule 1, item 23, section 154-10]***. A return of a non-fixed trust's contributed capital is generally only included in assessable income to the extent that it exceeds the cost base of the member's membership interest.

5.15 However, there will be an exception to this rule for some membership interests which have, and have always had, a zero cost base. Distributions of contributed capital made by family trusts to members with non-fixed membership interests will not be assessable provided that:

- the members receiving the distributions of contributed capital are part of the same family group as the family trust; and
- only individuals or members of the family group have contributed capital to the family trust.

Rules covering this measure will be introduced in a later Bill.

5.16 In determining the treatment of a distribution from contributed capital, the date of acquisition is also relevant as there are special rules for pre-CGT assets. Together these rules reflect the way in which taxation laws work generally to include a gain in assessable income on the disposal of an asset.

5.17 Where the distribution of contributed capital extinguishes the member's interest in the trust because, for example, the member has redeemed their membership interest in the entity or the distribution extinguishes any further rights they have to benefit under the trust, Division 157 (discussed in Chapter 4) tells the member how much of the distribution is from contributed capital and profits. Division 154 then tells the member how each amount is taxed.

5.18 A distribution of contributed capital to a former member or associate is generally assessable in full. This is because a former member or associate does not have a membership interest with a cost base to absorb the return of capital. The distribution will be taxed under the CGT provisions

Pre-CGT membership interests

5.19 Under the CGT provisions, a distribution of contributed capital that relates to a pre-CGT membership interest will not be included in assessable income (though it is not exempt income). A pre-CGT membership interest is one that was acquired before 20 September 1985. This is worked out by applying the acquisition rules in Division 109 of the ITAA 1997.

Distribution of prior taxed amounts

5.20 A distribution of an amount that has already borne tax under trust taxation rules (other than the non-fixed trust rules) is not assessable (and is not exempt income) provided the recipient of the amount is the 'tax free recipient' of the amount (this term is explained in paragraphs 5.26 to 5.27). ***[Schedule 1, item 23, section 154-50]***

5.21 These amounts, known as prior taxed amounts, are a further category of distribution (in addition to a distribution of profits or contributed capital). They are trust amounts that have borne tax under the ITAA 1936 before the non-fixed trust regime applied to the non-fixed trust but which have not been paid, or applied for the benefit of a member before the commencement of the regime. These amounts will commonly exist for non-fixed trusts in existence at the commencement of the non-fixed trust regime.

What is a prior taxed amount?

5.22 An amount is a ***prior taxed amount*** if it has borne tax (in an income year ending before the non-fixed trust regime began to apply to the trust) because it was:

- assessable income of a beneficiary under section 97 of the ITAA 1936;
- income on which a trustee was liable to pay tax under section 98 of the ITAA 1936 (because a beneficiary was under a legal disability or was a non-resident);
- net income on which a trustee was liable to pay tax under section 99 or 99A of the ITAA 1936 (because no beneficiary was presently entitled); or
- an amount on which a trustee of a closely-held trust (as in Division 6D of the ITAA 1936) was liable to pay tax because:
  - of a failure to disclose the identity of the ultimate beneficiary; or
  - there was no ultimate beneficiary.

[Schedule 1, item 23, subsection 154-55(1)

5.23 The trustee is liable for the prior tax in most of these cases, and accounts to the beneficiaries on a net basis, protected by section 254 of the ITAA 1936. In those cases, the prior taxed amount is the net amount. That is, it is the assessable amount less the amount of the tax liability ***[Schedule 1, item 23, subsection 154-55(1), items 2 to 4 in the table]***. For amounts that are assessable income of the beneficiary, where the trustee is not liable for the prior tax, the prior taxed amount is the gross amount, as this is the amount which may still be in the trustee's hands ***[Schedule 1, item 23, subsection 154-55(1), item 1 in the table]***. An amount will not qualify as a prior taxed amount if it has been applied for the benefit of a beneficiary, for example, by crediting it to the beneficiary's loan account where there is an implied or explicit agreement to lend the amount. Depending on the nature and the timing of when the loan was made, the amount may be part of the trust's contributed capital (discussed in Chapter 6). Furthermore, if the prior taxed amount has been distributed at a time when the trust was not subject to the non-fixed trust regime, it will no longer qualify as a prior taxed amount ***[Schedule 1, item 23, subsection 154-55(2)]***.

Distributing prior taxed amounts to tax-free recipients

5.24 It is not appropriate to tax prior taxed amounts again when they are distributed under the non-fixed trust regime to the beneficiary who paid the prior tax or in relation to whom it was paid (called the 'tax-free recipient'). Effectively tax has already been paid at the member level. Therefore, a prior taxed amount will not be included in the assessable income of a tax-free recipient. Also the amount is not treated as exempt income ***[Schedule 1, item 23, subsection 154-50(2)]***. However, a prior taxed amount will be assessable if distributed to someone who is not a tax-free recipient ***[Schedule 1, item 23, subsection 154-50(3)]***.

5.25 A distribution of a prior taxed amount to a tax-free recipient will not be subject to the profits first rule ***[Schedule 1, item 23, subsection 157-40(1)]***. That is, it can be separately distributed at any time ***[Schedule 1, item 23, paragraph 157-40(2)(a)]***. However, a distribution must be from prior taxed amounts if there are no available profits or contributed capital from which the distribution could have been made ***[Schedule 1, item 23, paragraph 157-40(2)(b)]***.

Who is a tax-free recipient?

5.26 A ***tax-free recipient*** of an amount taxed under section 97 or 98 of the ITAA 1936 is the beneficiary who was presently entitled to the amount that bore tax. A tax-free recipient of an amount taxed under section 99 or 99A of the ITAA 1936 is a beneficiary who was a member at the time the trustee was taxed. As the trustee was taxed because no beneficiary was presently entitled, anyone who could have been given the benefit of the income at that time will be a tax-free recipient. ***[Schedule 1, item 23, subsection 154-55(1), items 1 to 3 in the table]***

5.27 A ***tax-free recipient*** of an amount taxed under the non-disclosure of ultimate beneficiary provisions assessed under Division 6D of Part III of the ITAA 1936 is the ultimate beneficiary (if there was one) or any beneficiary of a trust in the chain of trusts at the time the trustee was taxed (if there was no ultimate beneficiary). As the trustee was taxed because no beneficiary was presently entitled, anyone who could have been given the benefit of the income at that time will be a tax-free recipient. ***[Schedule 1, item 23, subsection 154-55(1), item 4 in the table]***.

Prior taxed amounts will be an ongoing issue

5.28 Prior taxed amounts will be an ongoing issue for trusts which are fixed and become non-fixed and subsequently enter the regime as a result of a change in their status.

Summary of the tax treatment of distributions

5.29 Table 5.1 summarises the treatment of distributions. The treatment is discussed in more detail in paragraphs 5.6 to 5.28.

Table 5.1: Taxation treatment of distributions

No.	***Source of distribution***	***Made to a …***	***Tax treatment***
1	Profits	• member; or • former member or associate	assessable
2	Contributed capital	• member	generally, only assessable to extent it exceeds the cost base of the interest
3	Contributed capital	• former member or associate	generally assessable to the former member or associate
4	Trust prior taxed amounts	• tax-free recipient (who may be a current or former member)	• not assessable • not exempt
5	Trust prior taxed amounts	• other recipient	assessable

Distributions for which special rules may be needed

5.30 The taxation law currently treats some distributions concessionally. For example, a trust gain that attracts the CGT small business 15-year exemption can be distributed to certain members as an exempt amount. Rules are being developed, though they are not included in the exposure draft, to allow these types of concessions to continue after commencement of the non-fixed trust regime.

Application and transitional provisions

5.31 The non-fixed trust regime will apply from 1 July 2001.

Consequential amendments

5.32 Any consequential amendments required as a result of the measures discussed in this Chapter will be included in a later Bill.

Chapter 6
Contributed capital

Outline of Chapter

6.1 Subdivision 157-D includes an explanation of the amounts included in a non-fixed trust's contributed capital and the accounts those trusts need to keep to record this.

Context of reform

6.2 The non-fixed trust regime deals with contributed capital according to rules which are comparable to those that apply to the share capital of a company. The rules reflect the general proposition that the amount of capital contributed to an entity limits distributions out of contributed capital by the entity. The amount of contributed capital, and the extent to which each membership interest shares in it, must be determined according to appropriate rules so that the source of distributions can be determined in a fair manner.

6.3 The contributed capital rules applying to non-fixed trusts recognise amounts contributed or settled on a trust for membership interests (contributed capital) and the distribution by the trust of those amounts among its members. Receipt of contributed capital by a non-fixed trust is not taxable, and distributions to members of contributed capital are generally treated differently from profit distributions.

6.4 Identifying a non-fixed trust's contributed capital at any point in time is central to determining whether the trust has available profits when making distributions (under the 'profits first' rule). Alternatively, when a distribution relates to the cancellation of a member's interest, the contributed capital attributable to the cancelled interest must be determined (to apply the 'slice' rule).

6.5 In the same way that certain loans by non-fixed trusts to their members are in substance distributions and must be dealt with accordingly, certain loans by members to non-fixed trusts are really contributions of capital and must be dealt with accordingly.

6.6 The contributed capital of non-fixed trusts at the time the regime first applies to them is calculated under specific transitional rules.

Summary of new law

6.7 The amounts that form part of a non-fixed trust's contributed capital are summarised here.

What is contributed capital?	It is basically the contributions made to a non-fixed trust to create or to increase the value of membership interests in the trust. It includes amounts settled on a trust.
What additional amounts are treated as contributed capital?	Specific rules treat certain additional amounts as contributed capital to maintain substantively the tax treatment of certain realised gains and as part of transitional arrangements.

Comparison of key features of new law and current law

6.8 There is no concept of contributed capital for non-fixed trusts under the current law.

Detailed explanation of new law

6.9 A non-fixed trust must keep a contributed capital account and, where there are multiple classes of membership interests in the trust, sub-accounts. As part of applying these rules, increases and reductions in contributed capital need to be identified and taken into account, generally as they occur.

Why must non-fixed trusts keep contributed capital accounts?

6.10 Non-fixed trusts must keep a contributed capital account so they can work out how much of a distribution comes from contributed capital under either the profits first or slice rules.

6.11 Also, the source of the capital contributed to a non-fixed trust is used to determine whether a special rule applies to the tax treatment of distributions of contributed capital from non-fixed trusts (see further paragraphs 4.58 to 4.60 in Chapter 4).

What is contributed capital?

6.12 There are 2 broad types of contributed capital:

- amounts provided to a non-fixed trust by an entity, including amounts settled on a trust, to create or to increase the value available to membership interests in the trust; and

- certain realised gains credited to the trust's contributed capital account so those amounts will in substance maintain their current tax treatment on distribution.

6.13 A non-fixed trust's contributed capital is reduced by the amount of a distribution made from contributed capital. ***[Schedule 1, item 23, section 157-155]***

Capital contributed for membership interests

6.14 There are a number of ways in which an entity can contribute capital to a non-fixed trust. They include:

- providing amounts for the issue of membership interests (e.g. by subscribing for units in a non-fixed trust);
- providing amounts to allow interests in the non-fixed trust or for the trust itself to be created (e.g. by settling a trust);
- providing amounts to enhance the value of existing membership interests or trust assets (e.g. by settling additional property on an existing trust);
- making a 'non-commercial' loan (i.e. a loan that is in substance so substantially non-commercial that it amounts to a contribution of capital to the non-fixed trust);
- forgoing part of the repayment of a loan to a non-fixed trust that was not a contribution of capital; or
- forgiving a loan made to a non-fixed trust so far as the loan is not otherwise a contribution of capital.

[Schedule 7, item 16, definition of 'contributes capital' in subsection 995-1(1), referring to Schedule 1, item 23, sections 157-90 to 157-135]

6.15 The contribution may take the form of a payment or the transfer of an asset. The amount contributed is the amount of the payment or the value of the asset when transferred. In some circumstances an asset may include liabilities; for instance, land may be provided subject to a mortgage. In such cases the value of the asset is only the net value – the contribution cannot be taken to be larger than the value actually provided. ***[Schedule 1, item 23, subsection 157-90(1)]***

6.16 However, the transfer of an asset is only a contribution if the asset has a positive value in all the circumstances ***[Schedule 1, item 23, subsection 157-90(3)]***. That is, there is no contribution if liabilities attached to the asset or transferred with it, as part of the same transaction, exceed what would otherwise be its value.

6.17 This rule applies even where the liabilities do not attach to the asset itself; for instance, where an asset is contributed to a non-fixed trust on terms that other liabilities are assumed by the trust. The amount contributed is the excess value of the asset over the liabilities.

Issuing membership interests

6.18 The contributed capital of a non-fixed trust includes amounts provided to the trust as consideration for the issue or granting of interests in the trust. For example, consideration for the issue of new units is contributed capital as is bonus units that are taken to be distributions of profit under section 156-94 ***[Schedule 1, item 23, subsection 156-94(3)]***. The amounts must be provided as consideration, but receiving a membership interest need not be the sole purpose as, in this case there is a clear relationship between the issue or grant of particular membership interests and the contribution ***[Schedule 1, item 23, paragraph 157-90(1)(a)]***.

6.19 The contribution need not be made at the same time as the membership interest is issued; it could be made before or afterwards ***[Schedule 1, item 23, subsection 157-90(2)]***. Also, it need not be made by the holder of the membership interest; it could be made by someone else so that the membership interest will be issued.

6.20 An option to acquire a membership interest (e.g. a unit) will generally be consideration for the membership interest and hence the amount of the option will be contributed capital under the general rules.

Allowing membership interests (or the non-fixed trust) to be created

6.21 The contributed capital of a non-fixed trust includes amounts provided to the trust with any of a range of sole purposes. One is the sole purpose of allowing membership interests in the trust to be created ***[Schedule 1, item 23, subparagraph 157-90(1)(b)(i)]***. An example is subscribing for units in a trust to be formed, or for additional units in an existing trust.

6.22 A sole purpose test applies in order to distinguish effectively between dealings in respect of membership interests and dealings between taxpayers and the non-fixed trust which affect membership interests only incidentally. Thus, where a contribution is made with another purpose in mind, for example, in order to pass out value under the guise of contributed capital to a member, it will not be contributed capital.

Example 6.1

> ACE Enterprises owes Charles $500 for services rendered. Charles is a member of a non-fixed trust. ACE Enterprises pays $500 to the non-fixed trust so that it can distribute it, either as contributed capital or a franked distribution, to Charles. ACE Enterprises did not have the sole purpose of enhancing membership interests. Its purpose was to pass value to Charles other than by way of wages. The $500 will therefore not be a contribution of capital to the non-fixed trust.

6.23 A non-fixed trust may not be in existence when the contribution is made. The contribution may be the act that brings the trust into existence or may precede the acts that do so. To avoid doubt, it is specifically stated that contributed capital includes contributions made with the sole purpose of allowing a non-fixed trust to be created. ***[Schedule 1, item 23, subparagraph 157-90(1)(b)(ii)]***

6.24 An example of where this provision would be satisfied is cash or assets transferred to a trustee by the settlor to be held on trust for the purposes of the trust. The vesting of property in a trustee signals the creation of a trust and, at that point, the creation of membership interests of the beneficiaries. The settled amount is therefore contributed capital.

Enhancing the value of membership interests or assets in which a discretion may be exercised in favour of members

6.25 Property settled on commencement of a trust can be added to by subsequent settlements which will also be contributed capital. Such settlements are examples of payments or transfers made for the sole purpose of enhancing the value of existing interests (e.g. for fixed interests in a non-fixed trust) or the value of the assets in respect of which a discretion may be exercised in favour of members. ***[Schedule 1, item 23, subparagraphs 157-90(1)(b)(iii) and (iv)]***

Non-commercial loan (to a non-fixed trust)

6.26 A 'non-commercial' loan made by a member (or their associate) to a non-fixed trust, that is not fully repaid within 12 months after the end of the income year in which it was made, gives rise to a contribution of capital.

6.27 The contribution is taken to occur at the end of the 12 month period and the amount contributed is the amount that remains unpaid at the end of the period. ***[Schedule 1, item 23, subsection 157-115(1)]***

Other effects of the loan being a contribution of capital

6.28 A contribution of capital under this provision also gives the member an additional membership interest ***[Schedule 1, item 23, subsection 157-140(1); Schedule 7, item 1, subsection 960-120(1), item 5(d) in the table]***. The cost base of the membership interest at the time it arises is the amount of the loan that remains unpaid at that time ***[Schedule 1, item 23, subsection 157-140(3)]***. Subsequent repayments of capital or interest in respect of such loans are treated as a distribution from the trust to the member that is subject to the profits first rule ***[Schedule 1, item 23, subsection 157-140(2)]***.

6.29 Together these rules enhance the structural integrity of the non-fixed trust regime. In their absence, debt financing could be used as a substitute for equity funding. That is, loans could take the place of contributing capital and taking a membership interest in the entity. This would allow the trust to avoid the profits first rule by repaying the loan ahead of retained profits.

What is a non-commercial loan?

6.30 A ***non-commercial loan*** is one where:

- there is *no* written agreement;
- the interest rate in any year is *less* than the benchmark interest rate (i.e. Indicator Lending Rates – Bank variable housing loan rate); or
- its term is *more* than 25 years (or 7 years if the loan is not secured over real property).

[Schedule 7, item 1, subsections 960-180(1) and (2)]

6.31 A ***commercial loan*** is any loan that is not a non-commercial loan ***[Schedule 7, item 1, subsection 960-180(3)]***. A full explanation of these terms can be found in Chapter 3.

Commercial loan that is not repaid

6.32 A commercial loan made by a member (or their associate) to a non-fixed trust gives rise to a contribution of capital where either:

- the 'required interest payment' for the loan in the year following the income year in which the loan was made is not paid; or
- the loan principal is not fully repaid before the end of the term of the loan.

[Schedule 1, item 23, subsection 157-120(1)]

6.33 The 'required interest payment' is calculated by using the following formula:

$$\text{principal remaining unpaid at the end of the previous income year} \times \text{interest rate provided for in the loan}$$

[Schedule 1, item 23, subsection 157-120(4)]

6.34 The contribution of capital is taken to occur at the earlier of:

- the end of the first income year in which the non-fixed trust does not make the required interest payment; or
- the end of the term of the loan.

[Schedule 1, item 23, subsection 157-120(2)]

6.35 The amount of the contribution is equal to the amount of the principal that remains unpaid as at the time the contribution of capital is taken to occur ***[Schedule 1, item 23, subsection 157-120(3)]***. Any unpaid interest is not contributed capital. Adding interest to the trust's contributed capital account would artificially inflate the contributed capital account. The interest paid by the trust is thus treated according to general rules.

Non-commercial loans which are not amount contributions of capital

6.36 A loan does not amount to a contribution of capital if the loan is:

- between 2 non-fixed trusts;
- between one non-fixed trust and an associate of another non-fixed trust; or
- between 2 associates of 2 non-fixed trusts,

and the relevant non-fixed trusts are members of each other. This ensures that a loan in these circumstances is treated as a distribution and not a contribution of capital. ***[Schedule 1, item 23, subsection 157-115(2)]***

6.37 There is also no contribution of capital if the Commissioner so determines. In exercising that discretion, the Commissioner must have regard to the trust's capacity to repay, the circumstances that have reduced that capacity and whether the trust took all reasonable steps to make payments. ***[Schedule 1, item 23, section 157-125]***

Other effects of the loan being a contribution of capital

6.38 The effects are the same as for a non-commercial loan that is taken to be a contribution of capital. That is, the member acquires an additional membership interest with a cost base equal to the amount that remains unpaid and subsequent repayments by the non-fixed trust are treated as a distribution to the member subject to the profits first rule.

Commercial loans that are forgiven

6.39 A member or their associate also contributes capital to a non-fixed trust if they make a commercial loan to the trust that they wholly or partly forgive the loan. The amount of the contribution is the amount forgiven and the capital contribution is taken to occur at the time the loan is forgiven. ***[Schedule 1, item 23, subsection 157-135(1)]***

Other effects of the loan being a contribution of capital

6.40 The effects are the same as for commercial loans that remain unpaid however, the forgiving of a loan does not give rise to an additional membership interest as the member no longer holds any rights under the loan.

6.41 Also, the member or associate is taken to have received an amount equal to the contributed amount. This prevents a loss arising as a result of the loan being extinguished. ***[Schedule 1, item 23, subsection 157-135(2)]***

When is a loan forgiven?

6.42 This is explained by Subdivision 960-GA and discussed in Chapter 3. There does not need to be an agreement between the parties. For example, a loan will be forgiven if the period within which the lender is entitled to sue for the unpaid amount has passed. Also, a loan will be forgiven if the lender contributes capital to the borrowing non-fixed trust to enable them to make repayments. ***[Schedule 7, item 1, section 960-195]***

Tax effect for member of contributing capital

6.43 A contribution of capital to a non-fixed trust is not ordinarily a deduction to the entity making the contribution (though it may be so where the contribution is the cost of a membership interest which is trading stock).

6.44 The cost base of the membership interest to which the capital contribution relates will ordinarily be increased by the amount of the contribution. This may have the effect of reducing any capital gain or loss on disposal of the interest.

Credits to contributed capital account for certain assets

6.45 The contributed capital of non-fixed trusts will also include some realised gains that have not been taxed in the trust. Treating these amounts as contributed capital will, in substance, allow members to maintain their current tax treatment on distribution.

Non-transitional amounts

6.46 Realised capital gains on assets that qualify for the small business 15-year exemption may be added to the contributed capital account of a non-fixed trust. ***[Schedule 1, item 23, subsection 157-150(2), item 3 in the table]***

6.47 For an asset to qualify for the small business 15-year exemption, the basic conditions for small business relief must be satisfied. That is, the $5 million net asset threshold, the active asset test and the controlling individual test that applies to trusts must all be met. The non-fixed trust must also continuously own the asset for the 15-year period prior to the CGT event.

6.48 Realised capital gains on active business assets may also be added to the contributed capital of a non-fixed trust. The amount added is the amount by which a capital gain is reduced under the small business 50% active asset reduction in Subdivision 152-C of the ITAA 1997. ***[Schedule 1, item 23, subsection 157-150(2), item 4 in the table]***

6.49 This CGT reduction replaced the previous 50% CGT goodwill exemption for small business. The new 50% active asset exemption applies to businesses with net assets of $5 million or less.

6.50 An amount may be added to contributed capital under this provision regardless of when the relevant business assets were acquired. Contributed capital amounts that can be distributed as an exception to the profits first rule are discussed in Chapter 4.

Transitional amounts

6.51 The full effect of the special rules for non-fixed trusts is set out in Table 6.1 and can only be understood by looking at what happens on:

- commencement;
- the subsequent realisation of a CGT asset; and
- distribution of the realised proceeds.

6.52 In adding amounts to contributed capital as part of preserving current treatment within the non-fixed trust regime, the guiding principles are:

- unrealised gains are never added (though gains only deemed to be realised may be);
- amounts for which a deduction has been received are never added to contributed capital; and
- on the realisation of an asset, only untaxed gains (including gains untaxed because of a discount calculation) are added.

6.53 *On commencement* of the non-fixed trust regime, trusts will need to calculate their opening contributed capital balance. Start-up contributed capital is discussed in paragraphs 6.87 to 6.107.

6.54 Certain capital gains realised *after commencement* may be credited to the non-fixed trust's contributed capital account, namely:

- for assets the trust holds at 23 December 1999 – the trust can add the 50% discount capital gain (this was the date announced by Treasurer's Press Release, No. 93);
- for assets the trust holds before 11.45 am, AEST, on 21 September 1999 – the trust can choose to add either the 50% discount gain or the frozen indexation component of a capital gain;
- for assets the trust holds before 11.45 am, AEST, on 21 September 1999 – the trust can add the realised gains on pre-CGT assets; and
- for assets the trust holds that qualify for small business 15-year CGT exemption – the trust can add the realised gains.

6.55 These rules apply to non-fixed trusts existing before commencement of the non-fixed trust regime and for trusts which subsequently enter the non-fixed trust regime (i.e. because they become non-fixed). They are designed to maintain the current tax treatment of these concessional amounts on distribution.

50% discount or frozen indexation

6.56 These rules reflect recent changes to the CGT regime as a result of recommendations by the Review in its report *A Tax System Redesigned* and Treasurer's Press Release No. 93 of 23 December 1999 which clarified how those changes affect trusts that will be taxed like companies.

6.57 For assets the trust holds at 23 December 1999, the trust can add the 50% discount gain worked out under Subdivision 115-A of the ITAA 1997. The amount added to contributed capital is 50% of the capital gain remaining after applying capital losses and net capital losses of previous years. ***[Schedule 1, item 23, subsection 157-150(2), item 1 in the table]***

6.58 For assets the trust holds before 11.45 am, AEST, on 21 September 1999, the trust will to add to contributed capital either:

- 50% of the discount capital gain; or
- the cost base indexation component calculated up to the end of the September 1999 quarter,

that has been chosen to determine the capital gain of the trust. ***[Schedule 1, item 23, subsection 157-150(2), item 2 in the table]***

6.59 Indexation is not available for assets acquired after 11.45 am, AEST, on 21 September 1999. Therefore, there is no choice for assets acquired after that time – only the 50% discount gain is available. For assets acquired by all taxpayers before 11.45 am, AEST, on 21 September 1999, indexation has been frozen so that it can only be calculated up to the end of the September 1999 quarter.

6.60 The 50% discount gain and frozen indexation are both only available for assets held for at least 12 months prior to the CGT event that gave rise to the gain.

6.61 These amounts may be distributed as contributed capital regardless of the profits first rule if distributed within 12 months after the end of the income year in which the gain was realised. ***[Schedule 1, item 23, section 157-55]***

6.62 When distributed as contributed capital, whether as an exception to the profits first rule or in accordance with it, these amounts will receive the general contributed capital treatment. That is, the current provisions requiring the 50% gain to be grossed up in the hands of a beneficiary will no longer apply. The distribution will result in a reduction of the cost base of the membership interests in respect of which the distribution was made. The tax treatment of distributions is discussed in Chapter 5.

6.63 Allowing trusts to choose between the 50% discount and frozen indexation (for assets held before 21 September 1999) has been done in recognition of the Government's previous commitments about trust transitional amounts. Originally it was announced that all indexation (i.e. inflationary) gains for assets held at the *date of commencement* of the regime which would tax trusts like companies could be added to contributed capital.

6.64 Subsequently the commencement of the new regime was deferred to 1 July 2001 and it was announced that no indexation would be allowed for any assets acquired after 21 September 1999. It was therefore no longer possible for the Government to give exact effect to its previous commitment about the indexation component. So trusts have been given a choice. But, as for individual taxpayers, the choice is no longer available when indexation ceases.

6.65 It was announced in Treasurer's Press Release No. 93 of 23 December 1999 that the 50% discount continues to be available for assets held by trusts at 23 December 1999. The generous nature of the 50% discount would provide an incentive for taxpayers to move assets into a trust. Accordingly, the ability to add the 50% discount to contributed capital only exists for assets held at the date the arrangements were announced.

Profit on pre-CGT assets

6.66 A non-fixed trust adds to its contributed capital any profit made on an asset acquired before 20 September 1985. The amount added is the capital proceeds from a CGT event in relation to the asset less any amount previously added to contributed capital in relation to the asset, for example, on commencement. ***[Schedule 1, item 23, subsection 157-150(2), item 5 in the table]***

Contributed capital accounts

6.67 Every non-fixed trust subject to the non-fixed trust regime must maintain a contributed capital account. ***[Schedule 1, item 23, paragraph 157-145(a)]***

6.68 There is a credit to the account for each amount of capital contributed to the trust and for certain untaxed realised gains (discussed in paragraphs 6.14 and 6.51) ***[Schedule 1, item 23, subsection 157-150(2)]***. There is a debit to the account for each distribution made from contributed capital ***[Schedule 1, item 23, section 157-155]***.

Contributed capital sub-accounts

6.69 Non-fixed trusts with multiple classes of membership interests also need to keep records of the contributed capital attributable to each class of interest (called 'sub-accounts'). Where there is only a single class of interests, the trust's contributed capital account is also the sub-account for that class. ***[Schedule 1, item 23, paragraph 157-145(b) and subsection 157-195(1)]***

6.70 Membership interests form a ***class*** if they all carry strictly identical rights to distributions by the trust, even if they carry different rights in relation to some other matter such as voting rights. In a simple wholly discretionary trust, the objects of the trust form a single class because each object has the same rights in relation to distributions as every other – that is, no right beyond the right to have the discretions administered. ***[Schedule 7, item 11, subsection 995-1(1), definition of 'class']***

What are sub-accounts used for?

6.71 Sub-accounts are used in applying the slice rule. The source of a distribution related to the cancellation or termination of a membership interest is worked out using the slice rule. That involves working out the share of contributed capital and profits attributable to the cancelled interest. This is straightforward where the trust has only one class of interests. But where there are multiple classes, calculating the contributed capital attributable to each class is necessary to calculate the slice components of a distribution in a way that is fair to all members. No amount of contributed capital can be attributed to more than one class of membership interest. Capital is contributed to a particular class only to the extent to which the amount is provided in relation to membership interests of that class, or in relation to assets distributable among that class, so all amounts are counted once and only once. ***[Schedule 1, item 23, section 157-110, subsection 157-195(2)]***

Credits to sub-accounts

6.72 The sub-accounts, when added together, must equal (and must not exceed) the total of the trust's contributed capital. Each sub-account is credited with the capital contributions attributable only to the particular class of membership interests to which it relates, and with its share of contributions that are attributable more widely. ***[Schedule 1, item 23, subsection 157-195(2) and section 157-200]***

6.73 The sub-account credit provisions are linked to the different ways that contributed capital arises. Therefore, there is a credit to a sub-account for a membership class if:

- an amount is contributed in relation to a membership interest in that class under the general contributed capital rules ***[Schedule 1, item 23, paragraph 157-195(2)(a)]***; and
- the trust's contributed capital is otherwise increased by an amount treated as contributed capital and membership interests in that class carry rights to distributions of that kind ***[Schedule 1, item 23, paragraph 157-195(2)(b)]***.

6.74 Contributed capital amounts that cannot be allocated to a particular class are distributed proportionately among all classes on the basis of each sub-account's existing balance. ***[Schedule 1, item 23, paragraph 157-195(2)(c) and section 157-200]***

Debits to sub-accounts

6.75 There is a debit to a sub-account for a particular class if contributed capital is distributed in relation to a membership interest in the class. ***[Schedule 1, item 23, subsection 157-195(3)]***

6.76 If contributed capital is distributed to members of a class in excess of the balance of the sub-account attributable to that class, the balance of the class is reduced to nil and the excess which would otherwise be a negative amount for that class is spread across the other classes ***[Schedule 1, item 23, section 157-205]***. This ensures that the balance of a particular sub-account can never be a negative amount. An excess distribution in relation to a particular class could only occur under the profits first rule, and never the slice rule.

Trusts that become subject to the non-fixed trust regime

6.77 Fixed trusts are not subject to the non-fixed trust regime. However, if they subsequently become non-fixed, they will enter the non-fixed trust regime. In these circumstances, they will need to work out their contributed capital.

6.78 Their opening contributed capital on entering the regime will be the amount that would have been the balance of its contributed capital account if the non-fixed trust regime had applied to it at all times since commencement of the regime, or, if it did not exist then, at all times since it began to exist. ***[Schedule 1, item 23, section 157-175]***

6.79 The opening balance of a contributed capital sub-account for trusts which become subject to the non-fixed trust regime only after they have come into existence is worked out in the same manner as for previously existing trusts that enter the regime at commencement (see discussion in paragraphs 6.82 to 6.85). These special rules are not needed in relation to trusts to which the non-fixed trust regime applied from the time the trust comes into existence. ***[Schedule 1, item 23, subsection 157-180(1)]***

Application and transitional provisions

6.80 The non-fixed trust regime will apply from 1 July 2001.

6.81 A non-fixed trust in existence at commencement will need to work out the opening balance of its contributed capital as at that date, and the opening balance of its contributed capital sub-accounts as at that date. Thereafter, additions to, and reductions from, its contributed capital will be governed by the contributed capital rules.

6.82 The amount of a non-commercial loan made to a non-fixed trust on or after 22 February 1999 that remains unpaid on commencement will be included in the trust's start-up contributed capital. (In Press Release No. 10 of 1999, the Treasurer announced that action may be taken to address abuse of deficiencies in the business tax system that were identified in the Review of Business Taxation process with effect from 22 February 1999).

Opening balance of contributed capital sub-accounts

6.83 There are 2 methods for calculating the opening balance of contributed capital sub-accounts. ***[Schedule 1, item 23, subsection 157-180(2)]***

6.84 The first applies if the non-fixed trust has sufficient records to work out the balance of capital that has been contributed for the benefit of a particular class of membership interests, and the balance of capital that has been contributed for all classes of membership interests. In that case, the opening balance of the sub-account for that class will be the share of the opening balance of the contributed capital account for the trust according to the balance of the capital contributed for that class as a percentage of the total capital contributed for all classes. ***[Schedule 1, item 23, subsection 157-180(3)]***

6.85 The second method will apply if the trust does not have sufficient information to use the first. In that case the opening balance of the sub-account for a class is the share of the opening contributed capital for the trust according to the proportion of the market value of the membership interests in that class as a percentage of the total market value of all membership interests. Where the interests in the trust are wholly discretionary, the sub-account will be the opening balance of the contributed capital account. Where there are classes of fixed interests and classes of discretionary interests the trust must establish:

- the opening balance of the contributed capital account; and
- the market value of the fixed entitlements.

The market value of the discretionary interests is then the difference between the market value of the fixed entitlements and the opening balance of the contributed capital account. ***[Schedule 1, item 23, subsection 157-180(4)]***

6.86 For the purposes of this calculation, the market value of the membership interest is the market value immediately before the trust became subject to the non-fixed trust regime. ***[Schedule 1, item 23, subsection 157-180(5)]***

Start-up contributed capital of non-fixed trusts

6.87 The start-up contributed capital of non-fixed trusts will be the amount worked out under whichever of the following methods the trustee chooses:

- the prescribed value of the trust's assets less liabilities and prior taxed amounts (the valuation method); or
- the amount or value of contributions received less distributions made (alternative opening balance calculation).

[Schedule 1, item 23, section 157-160]

6.88 The option of using the contributions less distributions method has been granted in recognition of the fact that some trusts may not have sufficient records to value all their assets, and that it may produce a larger balance of contributed capital than the valuation method for some trusts. An inability to value some assets, such as pre-CGT assets, will not preclude the trust using the valuations method; the cost base of a pre-CGT asset can only be included if the trust can establish that it was acquired before 20 September 1985 and what its cost base is. ***[Schedule 1, item 23, subsection 157-165(2)]***

6.89 Because contributed capital is deducted from the net market value of assets in working out a non-fixed trust's available profits, it is to the trust's advantage to adopt whichever start-up method gives them a greater opening contributed capital.

Contributions less distributions method

6.90 Under this method, the contributed capital of a non-fixed trust in existence at commencement will be the amount of contributions of capital less the amount of distributions from such contributions, with these contributed amounts worked out as if the provisions of section 157-90 (the general rule on contributing capital) had always applied. ***[Schedule 1, item 23, section 157-170]***

Valuations method

6.91 The contributed capital of a non-fixed trust in existence at the commencement of the non-fixed trust regime that chooses this method is the sum of the following amounts held in the trust at that date:

- Australian or foreign currency;
- the opening balance of trading stock in the trust carried forward from the previous income year;
- amounts that would reduce the gross disposal proceeds in calculating the profit on disposal of a revenue asset (effectively, the adjustable values of revenue assets other than trading stock);
- the undeducted cost of plant; and
- the cost base of any other CGT assets in the trust immediately before commencement;

less:

- any amounts that have been deducted for capital allowances for CGT assets;
- the market value of the trust's liabilities; and
- any prior taxed amounts.

[Schedule 1, item 23, section 157-165]

Australian or foreign currency

6.92 This is a reference to cash on hand at commencement. Foreign currency is to be converted into its equivalent in Australian currency, using the exchange rates applicable immediately before commencement, for the purpose of working out the amount to be added to contributed capital. ***[Schedule 1, item 23, subsection 157-165(1), item 1.5 in the table and subsection 157-165(5)]***

Valuing trading stock

6.93 Trading stock is defined in section 70-10 of the ITAA 1997 and includes anything produced, manufactured or acquired that is held for the purpose of manufacture, sale or exchange in the ordinary course of a business and includes livestock. The amount to be added to contributed capital is the excess value of trading stock in the non-fixed trust that was included in the trust's assessable income under subsection 70-35(2) of the ITAA 1997 for the income year immediately prior to commencement. ***[Schedule 1, item 23, subsection 157-165(1), item 1.3 in the table]***

Valuing revenue assets

6.94 An asset will be a revenue asset if any profit or loss on its disposal or any other realisation will be included in assessable income, other than as a capital gain or under the trading stock or plant depreciation provisions ***[Schedule 7, item 74, definition of 'revenue asset' in subsection 995-1(1)]***. The amount to be added to contributed capital is the amount that would be deducted from the sale proceeds in calculating any profit. That will be the cost of the asset plus any subsequent capital costs, worked out as at the date of commencement ***[Schedule 1, item 23, subsection 157-165(1), item 1.4 in the table]***.

Valuing plant

6.95 The undeducted cost of plant is prescribed separately because any gain on the disposal of plant is, since 21 September 1999, to be disregarded for CGT purposes. Instead it is to be accounted for entirely under the depreciation provisions contained in Division 42 of the ITAA 1997. ***[Schedule 1, item 23, subsection 157-165(1), item 1.2 in the table]***

6.96 The undeducted cost of plant is basically the cost of the plant less any amounts that have been deducted for depreciation in relation to it or that could have been deducted had it been used entirely for business purposes. It represents the amount left available for deduction under the depreciation provisions. 'Undeducted cost' is defined in section 42-175 of the ITAA 1997.

Valuing CGT assets

6.97 The amount to be added for CGT assets, including CGT assets acquired before 20 September 1985 (pre-CGT assets), is their cost base worked out under Subdivision 110-A of the ITAA 1997 ignoring indexation. Indexation is not taken into account in working out the commencement amount, though it may be added to contributed capital on realisation of the asset (see paragraphs 6.55 to 6.66). ***[Schedule 1, item 23, subsection 157-165(1), item 1.1 in the table and subsection 157-165(3)]***

6.98 Subdivision 110-A ensures that the cost base of an asset acquired after 7.30 pm on 13 May 1997 does not include any amount for which a deduction is available. To that end, cost base is reduced by the net amount of revenue deductions. That is, by the amount of deductions less any amounts included in assessable income as a balancing adjustment that effectively reverses the deduction, see section 110-45 of the ITAA 1997.

6.99 For assets acquired before that time, only the second and third elements of cost base (i.e. costs of transfer and stamp duty) are reduced in this fashion by deductible amounts, see section 110-40 of the ITAA 1997. There is therefore nothing that prevents any part of the acquisition cost of the asset being deductible.

6.100 That is why the cost base rules were amended for assets acquired after 7.30 pm on 13 May 1997. It is also the reason special provision is made in the valuation method to reduce opening contributed capital. It is reduced by any amount allowed as a deduction for a capital allowance that has not already been deducted by natural operation of the cost base rules for CGT assets or undeducted cost for plant. ***[Schedule 1, item 23, subsection 157-165(1), item 2.1 in the table]***

Valuing pre-CGT assets

6.101 However, an amount should not be added under the valuation method for a pre-CGT asset if the non-fixed trust cannot establish both that it was acquired before 20 September 1985 and its cost base ***[Schedule 1, item 23, subsection 157-165(2)]***. In that case, no amount will be added on commencement, but the whole of the proceeds will be added on disposal if the trust can nevertheless establish that it was acquired before 20 September 1985 ***[Schedule 1, item 23, subsection 157-150(2), item 5 in the table]***.

Deduct the market value of liabilities (negative contributed capital)

6.102 General liabilities that attach to the trust and prior tax liabilities that attach to the trustee are to be deducted in working out its opening contributed capital balance.

6.103 Reducing start-up contributed capital of non-fixed trusts by liabilities and by 'prior taxed amounts' may result in a negative amount overall being credited to a trust's contributed capital account. If that happens, the opening value of the contributed capital account will be nil. This ensures that subsequent contributions for membership interests will be reflected by a positive amount of contributed capital instead of being diverted to soaking up debit amounts. It also avoids the difficulty of working out to which sub-account and to what extent debits are to be applied, if there are several classes of membership interest. ***[Schedule 1, item 23, subsection 157-165(4)***

6.104 Contributed capital should therefore never be a negative amount. However, in the unlikely event that contributed capital is negative for some other reason, then it will be taken to be nil for the purpose of calculating the trust's available profits or in applying the 'slice' approach. It will continue to be a negative amount for the purpose of adjusting the contributed capital account (and any relevant sub-accounts) as a result of further credits or debits. ***[Schedule 1, item 23, section 157-190]***

Example 6.2: Negative contributed capital at commencement

> The assets of the Share Holding Family Trust are shares in a publicly listed company. The shares have a cost base of $10,000.
>
> The trust acquired the shares in part with borrowed funds and, as a result of capitalising the interest on the debt, the liabilities of the trust on commencement are $12,000.
>
> The trust's contributed capital account has a negative balance of $2,000. On commencement, the balance will be nil.
>
> If a further $3,000 is then settled on the trust, the balance of the contributed capital account will be $3,000.

Prior taxed amounts

6.105 The prior taxed amounts of a non-fixed trust at commencement of the non-fixed trust regime will consist of previously taxed retained income of the trust. ***[Schedule 1, item 23, section 154-55]***

6.106 They are deducted from contributed capital at commencement date to prevent double counting as retained income is also reflected in the asset base of the non-fixed trust (which will be used to establish starting contributed capital). ***[Schedule 1, item 23, subsection 157-165(1), item 2.3 in the table]***

6.107 Prior taxed amounts benefit from a more favourable tax treatment than contributed capital amounts. ***[Schedule 1, item 23, section 154-50]***

Consequential amendments

6.108 Any consequential amendments required as a result of the measures discussed in this Chapter will be included in a later Bill.

6.109 Table 6.1 assumes the trust has used the valuation method on commencement.

Table 6.1: CGT concessional rules for non-fixed trusts – transitional and non-transitional

Item	*Asset*	*Add to contributed capital on commencement*	*Add to contributed capital on realisation*	*If asset was held…*	*Contributed capital that can be distributed as an exception to profits first*
1	CGT asset acquired by the trust *before* 20 September 1985	its cost base worked out ignoring indexation (or a nil amount if records are not sufficient)	realisation proceeds less the amount added on commencement	before 11.45 am on 21 September 1999	the gain on realisation
2	CGT asset acquired by the trust *on or after* 20 September 1985	its reduced cost base	50% discount gain	at 23 December 1999	the amount added on realisation
3	CGT asset acquired by the trust *on or after* 20 September 1985	its reduced cost base	50% discount gain or frozen indexation component	before 11.45 am on 21 September 1999	the amount added on realisation
4	CGT asset acquired by the trust *on or after* 20 September 1985	its reduced cost base	small business 50% active asset reduction	at any time	the amount added on realisation, but only if the asset was held by the trust before 11.45 am on 21 September 1999

Chapter 7
The imputation system

Outline of Chapter

7.1 This Chapter explains the new imputation system that accompanies the non-fixed trust regime, operative from 1 July 2001. In essence, the imputation system ensures that tax paid at the entity level is, in appropriate circumstances, imputed to the entity's members to avoid double taxation of entity profits.

7.2 This Chapter focuses on explaining the features of the new imputation system that differ from the current imputation system in Part IIIAA of the ITAA 1936. It also outlines the key features of the new provisions that essentially replicate the current Part IIIAA provisions. Some changes that will be made to the imputation system are not included in this Bill and will be included in a later Bill. These are:

- rules for refunding excess imputation credits;
- the tax treatment of dividends received indirectly through certain trusts or partnerships;
- franking credit trading rules;
- venture capital franking rebates;
- the application of the imputation system to life insurance companies;
- application and transitional provisions;
- consequential amendments; and
- machinery provisions.

Context of reform

7.3 The non-fixed trust regime and the existing income tax law tax certain entities (companies, non-fixed trusts, corporate unit trusts, public trading trusts and corporate limited partnerships) as taxpayers separate from their members. Members of these entities include shareholders, beneficiaries and partners.

7.4 Entities taxed in this way, called 'corporate tax entities', are taxed at the company tax rate, which will be 30% for the 2001-2002 and subsequent income years. To prevent double taxation of the distributed income of corporate tax entities (i.e. once when it is received by the entity and again in the hands of the members on distribution), the income tax paid by the entity will generally be imputed to the members. Providing the means for imputing the entity tax is the function served by both the current imputation system and the new provisions explained in this Chapter. The new imputation provisions will, broadly, provide the same outcome as the current rules. However, the mechanics of the new system are different.

7.5 Three structural changes underpin the new imputation provisions, which are redrafted in a clearer and more accessible style. Firstly, unlike the new provisions, the current system operates on a *qualified dividend account* basis under which a company's franking account – which records the tax credits that may be imputed to shareholders – is credited by the relevant after-tax profits. Thus, if a company derives $100 taxable profit and pays tax (at a 30% rate) of $30, it would credit its qualified dividend account (called the franking account) by $70 – the after-tax profit available for distribution. This approach requires complex conversion provisions if the company tax rate changes. To avoid this, the new imputation provisions provide that a corporate tax entity's franking account will record credits on a *tax-paid* basis. On this basis, the relevant credit in the above example would be $30 rather than $70.

7.6 Secondly, the rules governing the extent to which an entity must frank its distributions have been changed. The current imputation system contains complex 'frank first' rules that require companies to frank dividends to the maximum extent possible. This lack of flexibility is addressed under the new provisions by allowing the entity to determine its preferred franking rate within certain limits.

7.7 Thirdly, the new imputation system provides a simple and consistent treatment of distributions through the entity chain and out to individual investors. Greater integrity and consistency is provided by bringing companies and other corporate tax entities receiving franked distributions wholly within the imputation system instead of relying on the inter-corporate dividend rebate in section 46 of the ITAA 1936. The new system uses a consistent 'gross-up and credit' approach to prevent double taxation. Under this approach, as is currently the case for individuals, distributions to entities are 'grossed-up' for tax paid by the distributing entity and are taxable in the receiving entity's hands. A corresponding credit equal to the amount of the 'gross-up' is available to offset tax payable on the distribution or other income.

7.8 Apart from these 3 structural changes, the new provisions provide the same outcome as the former Part IIIAA of the ITAA 1936 except that:

- an entity's franking year is aligned with its income year to avoid the compliance costs that can occur under the current law where late balancing companies have different income and franking years;
- franking deficit tax is no longer able to be offset against income tax (this change recognises the greater access to imputation benefits through refunding excess imputation credits and prevents the reinstatement of tax preferences); and
- in certain cases a corporate tax entity may obtain franking credits from withholding tax paid on foreign distributions received (capped at 15% of gross distributions received) – see Chapter 2 for a full explanation of this measure.

Summary of new law

7.9 The new imputation system, which applies from 1 July 2001, deals with:

- the imputing of tax paid by corporate tax entities to their members (by franking distributions); and
- the claiming of the imputed tax by members against their own tax liability.

7.10 Corporate tax entities impute tax to their members by franking distributions made to them. The usual process for franking a distribution is summarised in Diagram 7.1.

Diagram 7.1: Usual process for franking a distribution under the new imputation system

Step 1: Establish a benchmark franking percentage.
(see paragraphs 7.72 to 7.77)

↓

Step 2: Make a determination allocating a franking credit to a frankable distribution having regard to the benchmark franking percentage.
(see paragraphs 7.38 to 7.51)

↓

Step 3: Make the distribution and provide a distribution statement to the recipient.
(see paragraphs 7.150 to 7.154)

↓

Step 4: Record a franking debit for the franking credits allocated.
(see paragraphs 7.167 to 7.169)

7.11 A resident recipient of a franked distribution will generally:

- 'gross-up' the amount of the distribution to reflect the before-tax profit of the corporate tax entity – that is, the amount of the distribution plus the attached franking credit (called an imputation credit in the hands of the recipient); and
- receive a tax offset (also referred to as a franking rebate) for the imputation credit.

7.12 In effect, the same treatment applies to taxpayers who receive franked distributions indirectly through a trust not covered by the non-fixed trust regime (other than a corporate unit trust or a public trading trust) or a partnership.

Comparison of key features of new law and current law

New law	*Current law*
Franking credits arising from income tax paid are expressed on a tax-paid basis (e.g. a $30 income tax payment results in a franking credit of $30). As a result, the tax offset received by a member	Franking credits arising from income tax paid are expressed on an after-tax distributable profits basis (e.g. a $30 income tax payment would result in a franking credit of

New law	***Current law***
equals the face value of the franking credit allocated to that member.	$70, assuming a 30% tax rate). As a result, the tax offset received by a member equals the adjusted amount of the franking credit allocated to that member. The adjusted amount reconverts the after-tax distributable profits to the amount of the underlying tax paid.
Corporate tax entities may select their preferred level of franking having regard to their existing and expected franking account surplus and the rate at which they franked earlier distributions.	Complex 'required franking rules' complemented by 'estimated debit determination' rules provide that a company must frank a dividend to the maximum extent possible on the basis of the surplus in its franking account at the time of payment of the dividend.
Resident corporate tax entities that receive a franked distribution from another corporate tax entity must 'gross-up' the distribution by the amount of the attached franking credit and are entitled to a tax offset in the same way as resident individuals and superannuation entities.	Resident companies that receive a franked dividend from another company must include the net amount of the dividend in assessable income and may receive the inter-corporate dividend rebate under section 46 of the ITAA 1936.
An entity's franking account will always be based on the entity's income year.	The franking year of a late balancing company may differ from its income year.
Franking deficit tax payable by a corporate tax entity cannot be offset against income tax payable by the corporate tax entity.	Franking deficit tax payable by a company can be offset against income tax payable by the company, but franking credits are reduced to the extent of the offset.
The franking account is a rolling balance account: the balance of the account at the end of the last day of an income year is brought forward to the beginning of the first day of the next income year. However, if the account is in deficit on the last day of an income year, the entity will be liable to pay franking deficit tax.	If the franking account is in surplus at year-end, the amount of that surplus will be carried forward and registered in the account as a credit on the first day of the following year. If the account is in deficit, that deficit will not be carried forward. However, the company will be liable to pay franking deficit tax.
An over-payment of corporate tax that eliminates a franking deficit at the end of an income year and is refunded shortly afterwards is addressed by a simple recalculation of franking deficit tax for that year.	Refunds of over-paid tax may result in a deficit deferral amount that triggers a liability to a separate tax (deficit deferral tax).

Detailed explanation of new law

Terminology

7.13 This section explains the terminology commonly used in relation to franking and imputation.

7.14 The *imputation system* is the taxation law governing how and when income tax paid by a corporate tax entity is imputed to the entity's members. It may also be referred to as the *franking system*, because the tax is imputed to members by means of 'franking' (in the sense of stamping or marking) distributions of the entity when made to members. In essence, a *franked distribution* is one that is marked as carrying tax credits that can be imputed to members. Those tax credits reflect the tax already paid by the entity on the entity's profits which are distributed to the member.

7.15 The tax credits that can be imputed to members are recorded in the entity's *franking account* as *franking credits*. Franking credits reflect income tax paid directly by the entity, or underlying tax paid through other corporate tax entities that is imputed to the entity. When a franked distribution is made to a member of an entity, the franking credit is referred to as an *imputation credit* in the member's hands. An imputation credit may be used by the member to reduce income tax. For individuals, superannuation entities, and registered charities and gift deductible organisations, *excess imputation credits* (i.e. the extent to which the imputation credits exceed tax payable by the member) are refundable.

7.16 Imputation credits usually reduce income tax by giving rise to a tax offset known as the *franking rebate*. In addition, if the recipient is a corporate tax entity itself, an imputation credit is also allowed as a franking credit in the entity's own franking account (which may, in turn, be distributed to the entity's members).

Which entities can impute tax to members?

7.17 Franking a distribution is the means by which an entity imputes to a member tax it has paid. Therefore, to impute tax paid to its members, an entity must be capable of franking a distribution.

7.18 For these purposes a distribution made by a corporate tax entity is a:

- dividend, or something taken to be a dividend, paid by a company;
- unit trust dividend paid by a corporate unit trust or public trading trust;

- distribution, or something taken to be a dividend, made by a corporate limited partnership; or
- distribution made by a non-fixed trust.

7.19 A member of a corporate tax entity includes a:

- beneficiary (or object) of a non-fixed trust;
- partner of a corporate limited partnership;
- member (including a shareholder) of a company; or
- unit holder in a corporate unit trust or public trading trust.

7.20 An entity may frank a distribution if it is a 'franking entity' when it makes the distribution.

7.21 A franking entity is a corporate tax entity that is a resident of Australia and is not a mutual life insurance company. ***[Schedule 2, item 1, subsection 160-20(2)]***

What is a corporate tax entity?

7.22 A corporate tax entity is a:

- company (a body corporate or any other unincorporated association or body of persons other than a partnership);
- corporate unit trust (see Division 6B of Part III of the ITAA 1936);
- public trading trust (see Division 6C of Part III of the ITAA 1936);
- non-fixed trust, other than an excluded or disregarded trust, (see Chapter 2); or
- corporate limited partnership (see Division 5A of Part III of the ITAA 1936).

7.23 The following entities are not corporate tax entities:

- an excluded trust;
- a disregarded trust;
- a fixed trust (other than a corporate unit trust or a public trading trust);
- a complying superannuation fund;

- a complying approved deposit fund; and
- a pooled superannuation trust.

Which corporate tax entities are excluded from franking distributions?

7.24 In addition to non-resident corporate tax entities, mutual life insurance companies are, consistent with the existing law, excluded from franking distributions. How does a corporate tax entity impute tax to members?

7.25 To impute tax it has paid to its members, a corporate tax entity must frank a distribution. A corporate tax entity franks a distribution by allocating a franking credit to the distribution. ***[Schedule 2, item 1, section 160-26]***

7.26 Franking credits can be allocated to frankable distributions only.

7.27 Franking credits may be allocated automatically to certain distributions by non-fixed trusts covered by the slice rule. This automatic allocation is discussed in paragraphs 7.52 to 7.53.

7.28 If franking credits are allocated to a frankable distribution, that distribution is a franked distribution if the corporate tax entity making the distribution is a franking entity at the relevant time. ***[Schedule 2, item 1, section 160-36]***

What are frankable distributions?

7.29 Not all distributions made by a corporate tax entity can be franked.

7.30 The rules for determining whether distributions made by companies, corporate limited partnerships, corporate unit trusts and public trading trusts are frankable differ from those for distributions made by non-fixed trusts. Essentially, the circumstances in which distributions made by corporate tax entities other than non-fixed trusts are frankable remain the same as under the current law. Distributions made by non-fixed trusts, however, are frankable in different circumstances. This is discussed in paragraphs 7.35 to 7.37.

Distributions by companies, corporate limited partnerships, corporate unit trusts and public trading trusts

7.31 Distributions by companies, corporate limited partnerships, corporate unit trusts and public trading trusts are usually frankable if they are (or are equivalent to) dividends under:

- the general definition in subsection 6(1) of the ITAA 1936;
- subsection 6BA(5) of the ITAA 1936 (bonus shares);

- section 47 of the ITAA 1936 (liquidators' distributions); or
- section 159GZZZP of the ITAA 1936 (off-market share buy-backs).

[Schedule 2, item 1, subsection 160-31(1) to (3)]

7.32 However, dividends from Norfolk Island companies that are from exempt income are not frankable ***[Schedule 2, item 1, paragraph 160-31(4)(b)]***. This is because, being exempt, double taxation is not possible even without the imputation system. Similarly, dividends paid by co-operatives for which a deduction is allowable under section 120 of the ITAA 1936 are not frankable ***[Schedule 2, item 1, paragraph 160-31(4)(a)]***. This is because the deduction takes the place of imputation as a means to avoid double tax.

7.33 Dividends that are debt dividends for the purposes of section 46D of the ITAA 1936 are not frankable, because they are akin to interest on a loan. Similarly, dividends covered by subsection 46M(3) or paragraph 46M(4)(a) of the ITAA 1936 are not frankable. This prevents the franking of distributions debited to certain untaxed sources (share capital and asset revaluation reserves). ***[Schedule 2, item 1, paragraphs 160-31(4)(c) and (d)]***

7.34 Another rule preventing inappropriate franking benefits being provided to members is that amounts taken to be a dividend under Division 7A of Part III of the ITAA 1936 are not frankable. ***[Schedule 2, item 1, paragraph 160-31(4)(e)]***

Distributions by non-fixed trusts

7.35 In essence, only distributions which are made out of available profits of the non-fixed trust are frankable distributions because only these distributions could result in double taxation if they were not franked. ***[Schedule 2, item 1, subsection 160-32(1)]***

7.36 A distribution that is neither from available profits nor contributed capital of a non-fixed trust is not frankable ***[Schedule 2, item 1, subsection 160-32(2)]***. Similarly, a distribution is not frankable to the extent that it is taken to be from untaxed profits under the slice rule ***[Schedule 2, item 1, subsection 160-32(3)]***. By definition, such profits have not been subject to taxation in the entity's hands and so there are no underlying franking credits to allocate to their distribution.

7.37 A distribution that arises under Subdivision 156-C (other than a bonus unit issue) is not a frankable distribution ***[Schedule 2, item 1, subsection 160-32(4)]***. This Subdivision is modelled on the existing Division 7A of Part III of the ITAA 1936: the inability to frank such distributions is consistent with the unfrankability of Division 7A distributions.

How is a franking credit allocated to a distribution?

7.38 A corporate tax entity allocates a franking credit to a frankable distribution by making a determination in writing. The determination may be that no franking credit will be allocated to a distribution, in which case the distribution will be unfranked. ***[Schedule 2, item 1, subsections 160-35AB(1) and (5)]***

7.39 If an entity fails to validly allocate franking credits or allocates no franking credits to a distribution, the distribution will be unfranked. ***[Schedule 2, item 1, section 160-26]***

7.40 An allocation determination does not need to be provided to the Commissioner, but should be kept by the entity as part of its tax records.

7.41 There are 2 types of allocation determination that a corporate tax entity may make:

- a specific allocation determination (which relates to a specified distribution); or
- a standing allocation determination (which relates to all distributions of the kind identified in the determination).

[Schedule 2, item 1, section 160-35]

7.42 These determinations are different from the benchmark franking percentage declaration explained in paragraphs 7.72 to 7.74. The allocation determination indicates the level at which franking credits are *actually* allocated to a distribution; the entity's benchmark franking declaration, on the other hand, sets a standard against which the allocation of franking credits is compared to determine whether the distribution is over-franked or under-franked.

Specific allocation determinations

7.43 An entity may allocate a franking credit by making a written determination in relation to a specified frankable distribution – a 'specific allocation determination' ***[Schedule 2, item 1, subsections 160-35AA(1) and (5)]***. This determination must state that a franking credit is allocated to that distribution at a particular percentage, or provide sufficient information to enable the franking percentage to be worked out ***[Schedule 2, item 1, subsection 160-35AA(2)]***. If the determination is in force at the time the specified distribution is made (i.e. if it has not been revoked or over-ridden by a subsequent determination), the distribution will be franked according to the allocation in the determination ***[Schedule 2, item 1, subsection 160-35AA(6)]***.

7.44 It is not necessary that a separate document be made for each distribution. Any number of specific allocation determinations may be set out in the one document. For example, a determination might provide that all distributions to be made to all ordinary shareholders on a specified day will be franked to a certain extent.

<u>When must an entity make a specific allocation determination?</u>

7.45 A specific allocation determination must be made at the time, or before, the distribution is made. It can be varied or revoked at any time up until the distribution is made. ***[Schedule 2, item 1, subsections 160-35AA(3) and (4)]***

Standing allocation determinations

7.46 Instead of making a specific allocation determination, an entity may make a written determination that allocates franking credits either to distributions generally, or to a particular kind of distribution ***[Schedule 2, item 1, subsection 160-35AB(1)]***. This type of determination is called a 'standing allocation determination'.

7.47 A standing allocation determination must be made at the time, or before, a distribution to which it applies is made. ***[Schedule 2, item 1, subsection 160-35AB(3)]***

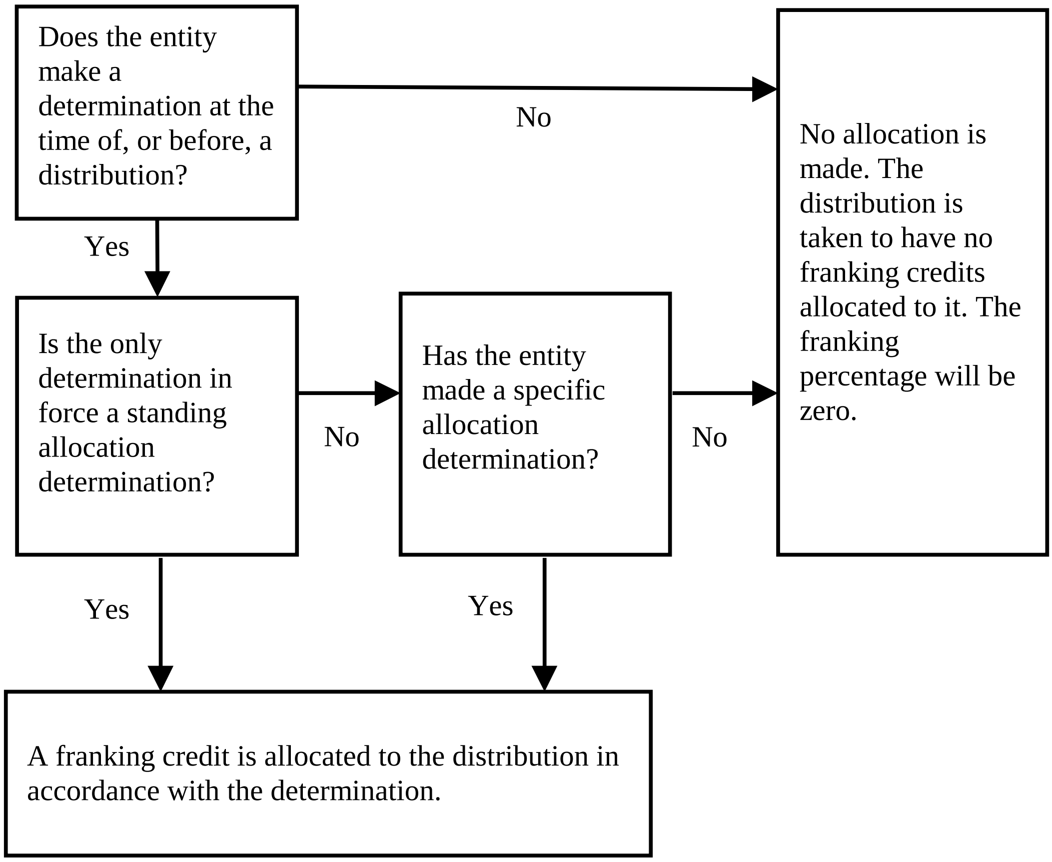
7.48 A standing allocation determination does not specify the particular distributions it covers, but it may describe the relevant class of distributions (such as all frankable distributions made during the year, or all distributions that arise as a result of providing property other than money to a person). A standing allocation determination will allocate credits to all relevant distributions while it is in force and where there is no specific allocation determination in respect of a particular distribution. ***[Schedule 2, item 1, subsection 160-35AB(5)]***

7.49 A standing allocation determination may apply indefinitely from the time it is made. Indeed, where the determination does not specify the period for which it applies, it will be taken to apply indefinitely. It can be revoked or modified at any time.

7.50 In effect, the standing allocation determination will set a default allocation of franking credits for each distribution it describes. This default allocation will apply unless a specific allocation determination is made. In other words, a specific allocation determination will override a standing allocation determination if a particular distribution is covered by both. ***[Schedule 2, item 1, subsection 160-35AB(5)]***

7.51 Diagram 7.2 summarises the way in which a corporate tax entity allocates a franking credit to a distribution.

Diagram 7.2: Allocating a franking credit to a distribution by determination



<u>Distributions covered by the 'slice rule'</u>

7.52 If a frankable distribution represents the taxed profit component of a distribution by a non-fixed trust covered by the 'slice rule', a franking credit is automatically allocated to it. The slice rule is set out in Subdivision 157-E – it provides that certain distributions involving rearrangements of membership interests are comprised of specified components, or slices, of the entity's contributed capital and its taxed and untaxed profits: see Chapter 4 for a full explanation of the rule. ***[Schedule 2, item 1, section 160-35A]***

7.53 Thus if a non-fixed trust makes a distribution that is dealt with under the slice rule, it is taken to allocate a franking credit to that part of the distribution that is taken to be from taxed profits at a franking percentage of 100%. This automatic allocation overrides any standing allocation or specific allocation determination in relation to the distribution. ***[Schedule 2, item 1, section 160-35A]***

What rules govern the extent to which franking credits can be allocated to a frankable distribution?

7.54 Subject to the rules explained in paragraphs 7.55 to 7.149, a corporate tax entity is free to frank (i.e. allocate franking credits to) a frankable distribution to whatever extent it considers appropriate. It will be able to select its preferred level of franking having regard to the existing and expected franking account surplus and the rate at which earlier distributions were franked. This differs from the current required franking rules, which require a company to frank a dividend to the maximum extent possible having regard to the surplus in its franking account at the time of its payment.

Franking percentage cannot exceed 100%

7.55 Consistent with the current law, however, a corporate tax entity cannot frank a distribution by more than 100% ***[Schedule 2, item 1, section 160-40]***. In other words, an entity cannot allocate a greater franking credit to a distribution than tax paid by the corporate tax entity on the underlying profits.

7.56 The percentage to which a distribution is franked is called the franking percentage. It is expressed as a percentage of the frankable part of a distribution, rather than of the whole of the distribution. Thus the franking percentage of a distribution may be 100% even if it is partly unfrankable. The franking percentage of a distribution is calculated as follows:

$$\frac{\text{franking credit allocated to the frankable distribution}}{\text{maximum credit that could be allocated to the distribution}} \times 100$$

[Schedule 2, item 1, subsection 160-45(1)]

Where:

the *maximum credit that could be allocated to a distribution* is the amount worked out using the formula:

$$\text{amount of the frankable distribution} \times \frac{\text{franking rate}}{1 - \text{franking rate}}$$

Where:

the *franking rate* is 30% (corresponding to the company tax rate for the 2001-2002 income year).

[Schedule 2, item 1, subsection 160-45(2)]

Example 7.1: Calculating the franking percentage

A corporate tax entity derives $100 taxable profits on which it pays tax (at 30%) of $30. The maximum franking credit that can be allocated to a distribution of the $70 after-tax profit is $30.

The entity distributes the $70 as part of a $200 distribution, $130 of which is from contributed capital and $70 from available profits. It allocates $30 franking credits to the distribution. The distribution is franked to 100% (i.e. it is fully-franked).

7.57 If an entity fails to comply with this rule and allocates a franking credit to a distribution at a franking percentage in excess of 100%:

- the entity's franking account is debited to the full extent of the allocation ***[Schedule 2, item 1, item 1, section 160-130 in the table]***;
- any additional amount included in the assessable income of the recipient of the distribution will not exceed the maximum franking credit that could be allocated to a distribution (i.e. the gross-up will not include the excess) ***[Schedule 2, item 1, subsection 161-215(2)]***; and
- any tax offset to which the recipient of the distribution is entitled will not exceed the maximum franking credit that could be allocated to the distribution ***[Schedule 2, item 1, section 161-220]***.

7.58 In other words, the distribution will be treated in the member's hands as if it were franked to 100% and no more, but the entity will incur a franking debit based on the actual allocation.

The benchmark rules

7.59 Once a corporate tax entity has franked a distribution to a certain extent, other frankable distributions made in the same 6 month period will generally have to be franked to the same extent. In addition, an entity will not be allowed to significantly increase or decrease the extent to which it franks distributions made in the subsequent 6 month period. This is because of the benchmark rules. Penalties apply if these rules are breached.

7.60 In broad terms, the benchmark rules provide that all frankable distributions of a corporate tax entity covered by the rules must be franked to the same or a similar extent. This ensures that franking credits representing tax paid on behalf of all members of an entity are not allocated to only some of them.

7.61 It is a fundamental principle of the imputation system that corporate tax entities should not be able to direct franked and unfranked distributions to members in a way that maximises the benefits to members. Otherwise, the cost to revenue would be higher than originally intended. Instead the benchmark rules ensure that, over time, the benefit of franking credits is spread more or less evenly across members in proportion to their ownership interest in the entity.

7.62 Arrangements undermining this fundamental principle constitute 'dividend streaming'. They include situations where unfranked distributions are streamed to members who have no need for franking credits so as to preserve the credits for those who benefit most from the credits. Dividend streaming is discussed in greater detail in paragraphs 7.96 to 7.149.

7.63 Due to the limited opportunities for streaming by widely-held companies with only one class of shares, the benchmark rules only apply to a company if:

- it is closely-held; or
- it is widely-held and has more than one class of shares.

A company has one class of shares if all the shares on issue have the same, or substantially the same, rights. ***[Schedule 2, item 1, subsections 160-50(1) and (2)]***

7.64 A summary of the benchmark rules is provided in Diagram 7.3 (benchmark rule 1) and Diagram 7.5 (benchmark rule 2).

Benchmark rule 1 – distributions within a franking period

7.65 Benchmark rule 1 effectively prevents a corporate tax entity making distributions to its members within a particular franking period that are franked to different extents, unless the Commissioner is satisfied that there is a legitimate (non-tax driven) reason for doing so.

7.66 The key elements of this rule, which are explained in paragraphs 7.68 to 7.77, are the ascertainment of the franking period and the setting of a benchmark franking percentage for that period. Once the benchmark franking percentage is established, the entity must frank all distributions made within the franking period using this percentage, or face penalties. ***[Schedule 2, item 1, subsection 160-55(1)]***

7.67 The rule does not apply, however, if the allocation of a franking credit is made to a distribution by a non-fixed trust dealt with under the slice rule ***[Schedule 2, item 1, subsection 160-50(3)]***. As explained in paragraphs 7.52 to 7.53, in this case the trust is taken to have allocated a franking credit to that part of the distribution that is from taxed profit at a franking percentage of 100% (and zero to the untaxed component) ***[Schedule 2, item 1, section 160-35A]***.

Ascertaining the franking period

7.68 A franking period for most corporate tax entities will be half of the income year of the entity. This will be the 6 month period either:

- beginning on the first day of the entity's income year; or
- ending on the last day of the entity's income year.

[Schedule 2, item 1, subsection 160-75(1)]

7.69 This rule will align the franking year and the income year for entities. This will correct an anomaly in the current law whereby some late balancing companies have a franking year that differs from their income year. The alignment of the income year and franking year will remove the complexities that arise under the current law for these companies.

7.70 For standard balancing entities therefore the franking period will be either the 6 month period:

- from 1 July to 31 December; or
- from 1 January to 30 June.

7.71 In the rare case of an income year being longer or shorter than 12 months, there may be up to 3 franking periods in the income year. ***[Schedule 2, item 1, subsections 160-75(2) to (4)]***

Setting the benchmark

7.72 The rate at which an entity should frank all frankable distributions for a particular franking period is the level chosen by the entity, the benchmark franking percentage.

7.73 An entity establishes its benchmark franking percentage for a franking period by making a benchmark declaration (in writing), or by franking a distribution during the period. If it does neither, a default rate may apply.

<u>Benchmark by declaration</u>

7.74 A benchmark declaration may be made at any time before the end of the franking period, unless a frankable distribution has already been made within that franking period. The declaration may be varied or revoked up until the time a frankable distribution is made. Once a frankable distribution has been made, any purported making, variation or revocation of the benchmark declaration is ineffective. ***[Schedule 2, item 1, subsection 160-65(3)]***

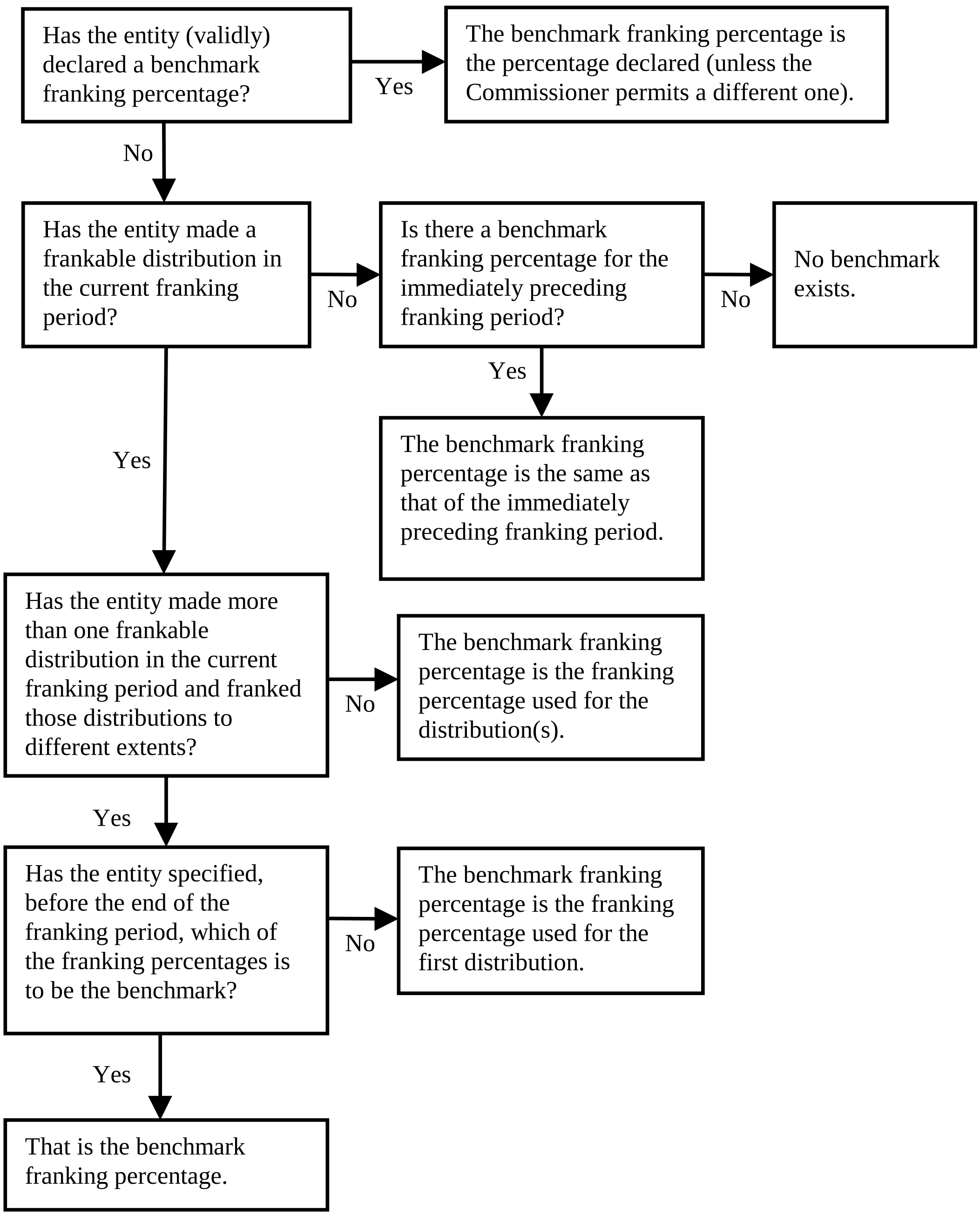
<u>Default benchmarks</u>

7.75 Instead of making a written benchmark declaration for a franking period, a corporate tax entity can simply frank a distribution made during the period to a certain extent. The benchmark franking percentage will be the franking percentage of this distribution if no other distributions are made during the period. ***[Schedule 2, item 1, subsection 160-70(1)]***

7.76 If an entity that has not established a benchmark franking percentage by declaration makes more than one frankable distribution during a franking period and franks them to a different extent, it may, before the end of the period, specify which franking percentage is to be the benchmark. If it fails to do so, the benchmark franking percentage will be the franking percentage of the first distribution. ***[Schedule 2, item 1, subsection 160-70(1)]***

7.77 If an entity fails to validly declare a benchmark franking percentage for a franking period and makes no frankable distribution during the period, it is taken to have the same benchmark franking percentage as it had in the preceding franking period. (If there is no benchmark franking percentage for the preceding franking period, there is no benchmark franking percentage for the period.) As a result of this default rule, once a corporate tax entity has established a benchmark franking percentage for a particular franking period, the entity will always have a benchmark for later franking periods even if it fails to declare one. Of course, the entity can vary the original benchmark franking percentage established. ***[Schedule 2, item 1, subsection 160-70(2)]***

Diagram 7.3: Default benchmark rules



Penalty for franking distributions differently within a franking period

7.78 A breach of benchmark rule 1 will not invalidate the allocation made to the distribution, but it will result in a penalty.

7.79 The penalty is calculated by reference to the difference between the franking credits actually allocated and the benchmark percentage. The penalty is either:

- over-franking tax, if the franking percentage for the distribution exceeds the benchmark franking percentage; or
- a franking debit, if the franking percentage for the distribution is less than the benchmark franking percentage.

[Schedule 2, item 1, subsection 160-55(2)]

7.80 The penalty debit for under-franking a distribution is in addition to the franking debit that arises from the payment of a franked distribution. It is equivalent to the extra franking credit that should have been allocated according to the benchmark rate. The additional debit effectively cancels out the unused credit. Therefore the penalty for under-franking by the entity is that the extra franking credit that ought to have been allocated to the distribution is wasted.

7.81 The amount of the penalty debit is worked out under the following formula:

$$\begin{array}{c}\text{franking \%}\\\text{differential}\end{array} \times \begin{array}{c}\text{amount of the}\\\text{frankable distribution}\end{array} \times \frac{\text{franking rate}}{1 - \text{franking rate}}$$

Where:

franking rate is 30%; and

franking % differential is the difference between:

- the franking percentage for the distribution; and
- the entity’s benchmark franking percentage for the franking period in which the distribution is made.

[Schedule 2, item 1, subsection 160-55(3)]

7.82 The amount of over-franking tax is calculated on the same basis as the penalty debit. It is imposed by a separate Bill, the New Business Tax System (Over-franking Tax) Bill 2000.

Example 7.2: Over-franking a distribution

Jeneris Ltd, a corporate tax entity, has established a benchmark franking percentage for the current franking period of 80%. Using this benchmark would mean that a frankable distribution of $700 would have $240 of franking credits attached.

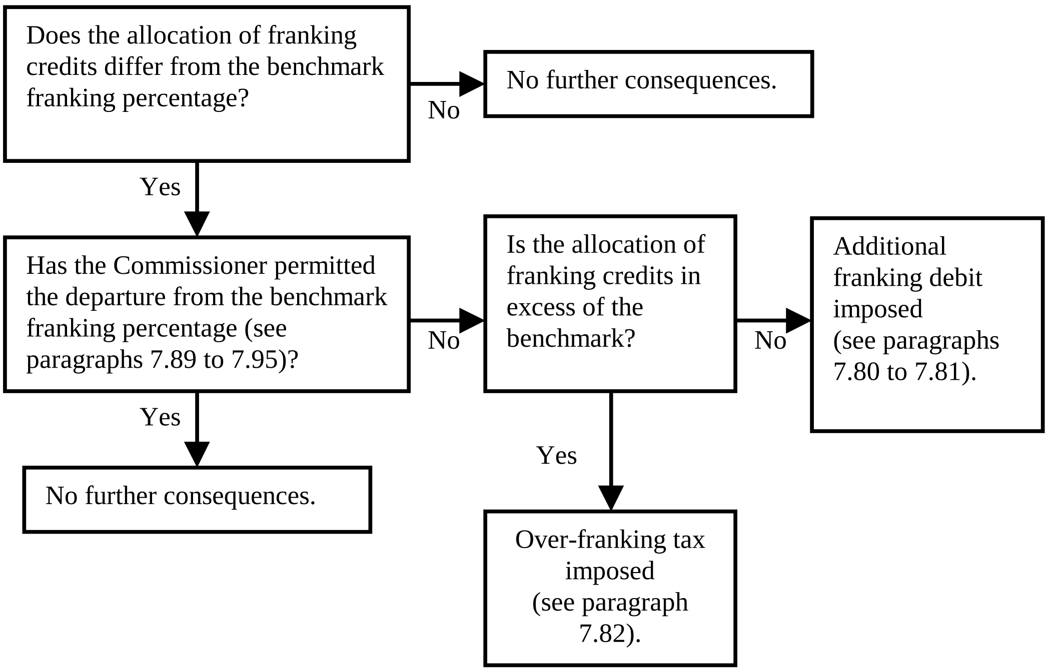
However, Jeneris Ltd makes a *fully* franked distribution of $700 within that franking period. In other words, it allocates a $300 franking credit (resulting in a franking percentage of 100%). The entity has over-franked this distribution and over-franking tax will be imposed.

The amount of the over-franking tax will be equivalent to the franking credit allocated in excess of that set under the benchmark. It is calculated on the same basis as a penalty debit would have been if the distribution were under-franked, that is:

$$(100\% - 80\%) \times \$700 \times (30\% \div 70\%) = \$60$$

7.83 Diagram 7.4 summarises the operation of benchmark rule 1.

Diagram 7.4: Benchmark rule 1



Benchmark rule 2 – distributions in consecutive franking periods

7.84 Benchmark rule 2 prevents the allocation of franking credits fluctuating significantly from one franking period to the next, unless the Commissioner is satisfied that there is a legitimate (non-tax driven) reason for doing so.

7.85 The rule does this by ensuring that the benchmark franking percentage of a particular franking period is no more than 20 percentage points different from the entity's benchmark franking percentage for the immediately preceding franking period (even if the preceding period is in a different income year) ***[Schedule 2, item 1, subsection 160-80(1)]***. Thus the benchmark franking percentage for a period is taken to be 20 percentage points higher or lower than the benchmark franking percentage for the immediately preceding franking period if an entity exceeds this tolerance ***[Schedule 2, item 1, subsection 160-80(2)]***.

7.86 It should be noted that an entity is allowed to change its benchmark franking percentage by an absolute amount of 20 percentage points as distinct from a relative variation of 20%. Thus, for example, a corporate tax entity may increase its previous period's benchmark franking percentage of 20% to 40%, notwithstanding that, in relative terms, this constitutes a 100% increase.

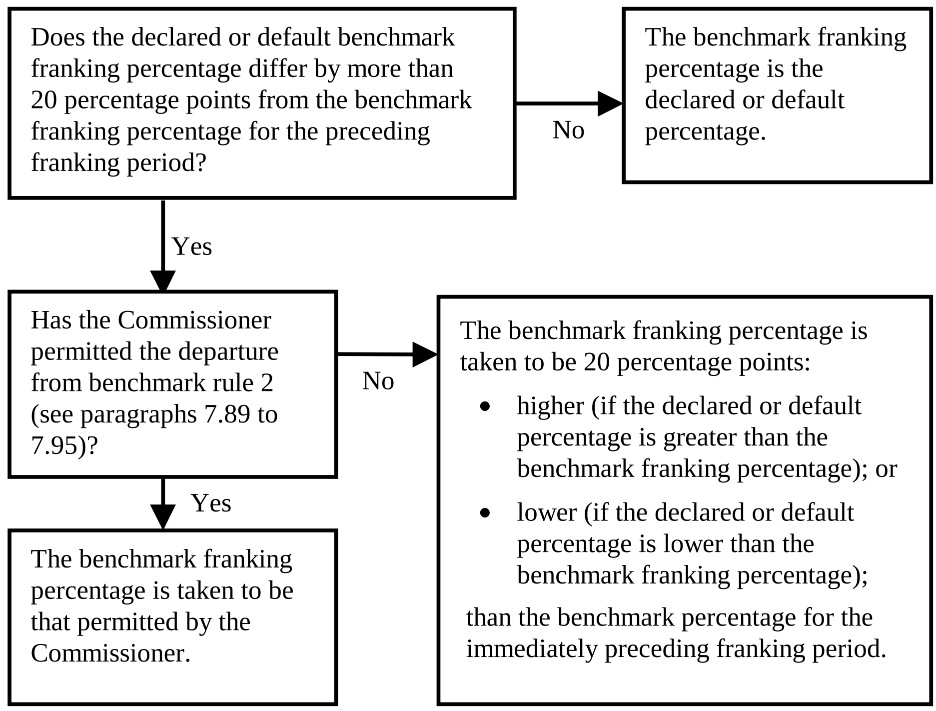
7.87 The effect of benchmark rule 2 is that an entity that purports to set a benchmark franking percentage that falls outside the permitted tolerance, and makes a distribution franked in accordance with the purported benchmark franking percentage, will incur either over-franking tax or a penalty franking debit under benchmark rule 1.

Example 7.3: Operation of benchmark rule 2

> Brooks Ltd, a corporate tax entity, is a company with an income year ending on 30 June. As discussed in paragraph 7.72, it will have franking periods of 1 July to 31 December (the first franking period) and 1 January to 30 June (the second franking period).
>
> On 1 July 2001, Brooks Ltd declares a benchmark franking percentage of 40% for the first franking period. The company makes distributions within that period and does not vary or revoke that declaration.
>
> On 1 January 2002, Brooks Ltd declares a benchmark franking percentage of 70% for the second franking period. Since the declared benchmark franking percentage differs by more than 20 percentage points from the declared benchmark franking percentage for the immediately preceding franking period, benchmark rule 2 will limit that variation to 20 percentage points. Therefore, the benchmark franking percentage for the later period will be taken to be 60%.

7.88 Diagram 7.5 summarises the operation of benchmark rule 2.

Diagram 7.5: Benchmark rule 2



Commissioner's power to permit departure from benchmark rules

7.89 A corporate tax entity may apply to the Commissioner in writing, either before or after a distribution is made, for permission to depart from benchmark rule 1 or benchmark rule 2. ***[Schedule 2, item 1, section 160-85]***

7.90 An entity seeking permission to depart from the benchmark rules should include all relevant information in support of the application. In particular, the application should address the following factors, which must be considered by the Commissioner in making a decision:

- the entity's reasons for wanting to depart from the relevant benchmark franking percentage;
- the extent of the departure (the greater the departure, the greater the onus on the corporate tax entity to justify it);
- whether the entity has previously sought the exercise of the Commissioner's powers to permit the departure in the past (assuming the previous applications resulted from circumstances within the entity's control – if so, the onus on the entity to justify a departure will increase if the entity applies for a variation relatively frequently);

- whether a member of the entity will be disadvantaged by the departure (e.g. because the member will receive a distribution with a lower franking percentage than the distribution received by another member);
- whether a member of the entity will receive franking benefits in preference to other members of the entity as a result of the departure (in such a case the departure may be motivated by a desire to stream franking credits inappropriately); and
- any other matters that the Commissioner considers relevant.

[Schedule 2, item 1, subsection 160-85(5)]

Power to be exercised in extraordinary circumstances only

7.91 The power to permit a departure from a benchmark percentage will be exercised by the Commissioner only in extraordinary circumstances. Thus the circumstances justifying a departure would generally need to be unforeseeable and beyond the control of the entity, its members and controllers. ***[Schedule 2, item 1, subsection 160-85(1)]***

7.92 A change in ownership of an entity would rarely amount to extraordinary circumstances sufficient to warrant a departure from a benchmark percentage.

Example 7.4: Permitted departure from benchmark rule 1

McDonald, a corporate tax entity, is a primary producer. In the current franking period, its benchmark franking percentage is 80%. It declares a distribution, expecting a credit to arise in its franking account from a tax instalment to be paid later in the franking period.

The distribution will be made from profits arising from the sale of its crops. However, shortly before harvest heavy flooding devastates the crops. Therefore, McDonald pays less tax than it had expected and receives only a small credit to its franking account.

McDonald applies to the Commissioner for permission to depart from its benchmark franking percentage.

These would be extraordinary circumstances since they are unforeseeable and beyond the control of McDonald. The Commissioner would consider all the relevant circumstances in deciding whether to permit a departure from the benchmark rules. Note that if McDonald were to apply for permission to deviate from its benchmark in a later franking period, the later application would not be weakened because McDonald had made this application.

Extent of departure permitted

7.93 A distribution that is franked in accordance with the Commissioner's permission to depart from the relevant benchmark rules is taken to comply with the benchmark rule to which the permission relates ***[Schedule 2, item 1, subsections 160-85(6) and (7)]***. That is, where the Commissioner permits deviation from a benchmark rule the entity is taken to comply with the rule so long as it does not deviate from the rule by more than was permitted.

7.94 The Commissioner may determine the extent of departure from the relevant benchmark rule that will be permitted. That is, the Commissioner may allow an entity to:

- differentially allocate franking credits to distributions; or
- set a benchmark franking percentage,

at a level other than the level sought by the entity. ***[Schedule 2, item 1, subsection 160-85(2)]***

7.95 If the Commissioner permits the setting of a benchmark franking percentage for a period that differs by more than 20 percentage points from the previous period's benchmark, any penalties for failing to comply with benchmark rule 1 (franking distributions differentially within a franking period) will be calculated on the basis of the difference (if any) between the franking percentage used and the benchmark franking percentage the Commissioner has permitted the entity to use. ***[Schedule 2, item 1, section 160-55 and subsection 160-85(7)]***

Example 7.5: Commissioner's permission to depart from the benchmark rules

> Trimble Ltd is a corporate tax entity that has a benchmark franking percentage of zero for a particular franking period. In the following period, the company wishes to set a benchmark franking percentage of 100%. The entity applies to the Commissioner for permission to do so.
>
> The Commissioner determines, having regard to the relevant factors, that a benchmark franking percentage of 50% is appropriate. Notwithstanding this determination Trimble Ltd makes a distribution allocating franking credits using a franking percentage of 100%.
>
> Over-franking tax will be imposed on the entity for franking inconsistently with the benchmark franking percentage, as set by the Commissioner's determination. That is, the over-franking tax will be based on the excess of the franking percentage applied (50%) over the benchmark franking percentage the Commissioner has permitted (50%).

Anti-streaming rules

7.96 The benchmark rules described above lay down the framework for ensuring that, over time, the benefit of franking credits is spread more or less evenly across members in proportion to their ownership interest in the entity. To prevent the undermining of this framework, 3 specific rules are required to ensure that franking credits representing tax paid on behalf of all members of an entity are not allocated to only some of them. These rules are referred to as anti-streaming rules, because they prevent the streaming, or disproportionate allocation, of franking credits to certain members.

7.97 The first anti-streaming rule, explained in paragraphs 7.104 to 7.112, is based on subsections 160AQCB(3) and (4A) of the ITAA 1936. It applies to streaming arrangements involving linked distributions, where a member of one entity can choose to receive a distribution from another entity that is franked to a greater or lesser extent than distributions made to other members of the first entity. This rule supplements benchmark rule 1, which applies where distributions franked to a different extent are made by the same entity.

7.98 The second anti-streaming rule, explained in paragraphs 7.115 to 7.119, is based on subsection 160AQCB(2) of the ITAA 1936. It applies to streaming arrangements involving tax-exempt bonus shares, where a member of an entity can choose that tax-exempt bonus shares are issued to the member, or to another member of the entity, instead of receiving a franked dividend.

7.99 The third anti-streaming rule, explained in paragraphs 7.120 to 7.149, replicates section 160AQCBA of the ITAA 1936. It applies to arrangements where an entity streams distributions to provide imputation benefits to members who benefit more from imputation credits than other members.

7.100 To gain a full understanding of the anti-streaming rules it is necessary to understand the underlying policy.

7.101 Where members hold interests in the profits of a corporate tax entity, the policy is that credits for tax paid on behalf of all members should not flow to only some of them. The franking rules do not, in general, attempt either to track the source of distributed profits or the particular members who hold an interest in a corporate tax entity at any given time. However, the policy of the tax law assumes that the benefit of imputation will, over time, be spread more or less evenly across members in proportion to their holdings in a corporate tax entity, having regard to any particular rights that attach to those holdings.

7.102 A consequence of generally spreading imputation benefits evenly across members is that members who cannot use, or cannot fully use, imputation benefits will nevertheless receive franked distributions. This results in the ‘wastage’ of those benefits, which is a design feature of the imputation system. Wastage of imputation benefits also includes the failure to use franking credits attributable to profits that are never distributed.

7.103 The benchmark rules and the anti-streaming rules ensure that the intended wastage of imputation benefits is not undermined.

Streaming using linked distributions

7.104 The benchmark franking rules could be circumvented if members of a corporate tax entity were able to choose to receive a distribution from another corporate tax entity in substitution for a distribution with a different benchmark percentage from the first entity.

7.105 To prevent this, a penalty franking debit will arise when a member of an entity who would otherwise receive a distribution from the entity can choose to receive a distribution with a higher or lower franking percentage from another entity. The distribution received from the other entity is called a 'linked distribution'.

7.106 A penalty franking debit will also arise where a member of an entity can decide that a member of another entity will receive a distribution rather than receiving a distribution franked to a different extent. An election of this nature might be made by a member if an associate of the electing member was the recipient of the distribution from the other entity.

7.107 This rule would apply, for example, where stapled stock arrangements are used for streaming. Under these arrangements, holders of stapled stock can choose to receive either a franked or an unfranked (or a lesser franked) dividend depending on the company paying the dividend. These arrangements might be used in an attempt to stream franked dividends to Australian resident shareholders of a company group and unfranked dividends to non-resident shareholders (who receive less benefit from imputation credits).

<u>What are the consequences of streaming using linked distributions?</u>

7.108 If the linked distribution streaming rule applies, one of the entities involved in the arrangement will incur a penalty franking debit. The franking debit imposed is equal to the debit that would have arisen if the relevant entity had made the linked distribution at its benchmark franking percentage. ***[Schedule 2, item 1, subsection 160-86(2)]***

7.109 The penalty debit is imposed on the entity with the higher benchmark franking percentage ***[Schedule 2, item 1, subsection 160-86(2)]***. If the electing member would, but for the election, have received a distribution with a higher franking percentage than the distribution made by the other entity, the electing member's entity will incur a franking debit (assuming that that entity's benchmark franking percentage is also higher). If, on the other hand, the forgone distribution had a lower franking percentage (reflecting a lower benchmark franking percentage), the entity making the linked distribution (with a higher franking percentage) will incur the franking debit. The debit is not imposed on the electing member's entity in all cases because that entity may be a non-resident entity, particularly where the forgone distribution is an unfranked distribution.

7.110 It is possible that the entity which gives its members a choice whether to receive a distribution from another entity rather than from it does not itself have a benchmark franking percentage for the relevant franking period. In this case, a hypothetical benchmark franking percentage is attributed to the entity. This hypothetical benchmark franking percentage is the benchmark franking percentage for the franking period that would have arisen under paragraph 160-70(1)(b) if the entity had itself made the distribution which is substituted by the distribution made by the other entity. ***[Schedule 2, item 1, subsection 160-86(6)]***

7.111 This means that, if subsection 160-86(1) is satisfied and the entity giving the member a choice has no benchmark franking percentage for the franking period in which the linked distribution is made, a franking debit will arise if the franking percentage of the linked distribution differs from the benchmark franking percentage for the franking period that the entity would have had under paragraph 160-70(1)(b) if the entity had made the distribution in the franking period. If the hypothetical benchmark franking percentage of the entity is higher than the benchmark franking percentage of the entity making the linked distribution, the debit will arise in the franking account of the first entity.

7.112 Similarly, for the purpose of determining which entity has the higher benchmark franking percentage, the entity that pays the linked distribution is taken to have a benchmark of zero if it does not already have a benchmark. ***[Schedule 2, item 1, subsection 160-86(7)]***

<u>Comparison with section 160AQCB</u>

7.113 The linked distribution streaming rule covers the same circumstances as subsections 160AQCB(3) and (4A) of the ITAA 1936. However, the franking debit is calculated by reference to the new benchmark franking percentage concept.

7.114 The circumstances to which subsection 160AQCB (1) of the ITAA 1936 applies are covered by the benchmark franking percentage rules and the rule covering the streaming of benefits to members who benefit more from imputation than others.

Streaming using tax-exempt bonus shares

7.115 The tax-exempt bonus shares streaming rule covers the same circumstances as subsection 160AQCB(2) of the ITAA 1936. However, as with linked distributions, the franking debit is calculated by reference to the new benchmark franking percentage concept.

7.116 The benchmark franking rules could be circumvented if members of an entity were able to choose to receive tax-exempt bonus shares, or for tax-exempt bonus shares to be issued to another member of the entity, in substitution for a distribution (‘the substituted distribution’) from the entity.

What are tax-exempt bonus shares?

7.117 Tax-exempt bonus shares are shares issued to a shareholder of a company in the circumstances described in subsection 6BA(6) of the ITAA 1936 (broadly speaking, bonus shares issued by a listed public company without crediting the share capital account). For those few companies that still have par value shares, tax exempt bonus shares are shares paid up by debiting the share premium account. ***[Schedule 2, item 1, subsections 160-86A(4) and (5)]***

What are the consequences of streaming using tax-exempt bonus shares?

7.118 To prevent this type of streaming, a penalty franking debit arises when a member of an entity who would otherwise receive a distribution from the entity can choose that the member, or another member, receives tax-exempt bonus shares. An election that another member receives the shares might be made by a member if the other member were an associate of the electing member. ***[Schedule 2, item 1, subsection 160-86A(1)]***

7.119 If the tax-exempt bonus shares streaming rule applies, the entity involved in the arrangement will incur a penalty franking debit. The franking debit imposed is equal to the debit that would have arisen if the entity had made the substituted distribution at its benchmark franking percentage or, if it has none, what would have been its benchmark franking percentage had it made the substituted distribution. ***[Schedule 2, item 1, subsections 160-86A(2) and (6)]***

Streaming benefits to members who benefit more from imputation than others

7.120 The third of the specific anti-streaming rules applies where a corporate tax entity streams distributions in such a way as to give those members who benefit most from imputation credits (e.g. taxable residents) a greater imputation benefit than those who benefit less (e.g. non-residents). The rule applies regardless of whether the streaming occurs within a single franking period or between different franking periods. ***[Schedule 2, item 1, subsection 160-87(1)]***

7.121 The streaming may occur by making franked distributions to some members of the entity and unfranked (including unfrankable) distributions to others. It may also occur, for example, by making franked distributions to some members and providing non-distribution benefits (e.g. superannuation contributions) to others. ***[Schedule 2, item 1, subsection 160-87(2)]***

What is streaming?

7.122 Streaming is selectively directing the flow of franked distributions to those members who can most benefit from imputation credits.

7.123 The law uses an essentially objective test for streaming, although purpose may be relevant where future conduct is a relevant consideration. It will normally be apparent on the face of an arrangement that a strategy for streaming is being implemented. The distinguishing of members on the basis of their ability to use franking benefits is a key element of streaming.

7.124 Thus, streaming is unlikely to occur when a corporate tax entity, in making franked distributions, distinguishes between 2 classes of members, both of which comprise members who can and who cannot benefit from imputation credits. However, where one class is predominantly able to use imputation credits, and the other predominantly not, it may be apparent that an arrangement is streaming notwithstanding the presence in each class of a small minority of the other type of member.

7.125 Broadly speaking, any strategy directed to defeating the policy of the law by avoiding wastage of imputation benefits through directing the flow of franked distributions to members who can most benefit from them to the exclusion of other members may amount to streaming. While it is not possible to specify in detail every combination of circumstances which can constitute the streaming of franking credits (which in some cases may involve questions of degree), some guidance is given in the following paragraphs.

7.126 In the simplest case of streaming, the members who can benefit from imputation credits receive a franked distribution, while members who cannot benefit to the same degree (e.g. non-residents) or who receive no benefit (e.g. tax-exempt organisations) simultaneously receive an unfranked distribution (normally adjusted in amount for the lack of franking).

7.127 However, it is not necessary for there to be 2 distributions by the corporate tax entity for streaming to occur. For example, in more complex cases of streaming, while the members who benefit most from imputation credits will receive a franked distribution from the entity, the other members may receive benefits from persons other than the entity, or they (or the entity) may defer the realisation of their share of the profits derived by the entity. Benefits may also be directed to associates of members. In some cases, described below, where the member less able to benefit from imputation is a corporate tax entity, trust or partnership, streaming may involve by-passing the member in favour of its ultimate owners.

7.128 Members less able to benefit from imputation credits may not receive unfranked distributions at the time the other members get franked distributions, and instead realise their interest in the corporate tax entity's profits in some other way, either at the same time or in the future. In this case, streaming will occur where it is apparent that the corporate tax entity or the members less able to benefit from imputation credits have deferred or avoided the distribution of their interest in profits as part of a strategy to avoid the wastage of imputation benefits. On the other hand, it would not be streaming if there is merely a deferred distribution of profits to one group of members which it is reasonable to expect will be franked (to a similar percentage) when it is distributed, or, if it is unfranked, will not be unfranked as the result of any strategy to direct franking to members most able to benefit from franking. In these cases it is appropriate to look to the intentions of the entity and members, and to the pattern of distributions among the members.

Example 7.6: Single distribution streaming by a non-resident controlled company

A non-resident controlled company with resident minority shareholders adopts a strategy of distributing all its franking credits to the minority shareholders while retaining the share of profits belonging to the controlling shareholder in the company. It does this with a view to ultimately paying an unfranked dividend, or paying some other benefit to the majority shareholder, or someone else, in lieu of a dividend (which would include realising accumulated profits as a capital amount on the sale of shares).

This would constitute streaming. On the other hand, if the non-resident majority shareholder merely deferred distributions in order to provide more equity capital for its subsidiary, but ultimately takes franked distributions, that would not be streaming.

Example 7.7: Share buy back – limited franking surplus

A corporate tax entity has members with differing abilities to benefit from franking and a limited supply of franking credits. It makes a franked distribution by buying back off-market the shares owned by taxable residents to stream the limited franking credits available to those who can most benefit from them.

This would constitute streaming. Alternatively, where there remain sufficient franking credits to frank distributions to the remaining shareholders, streaming would not occur, absent other special features. Special features are present in Example 7.8.

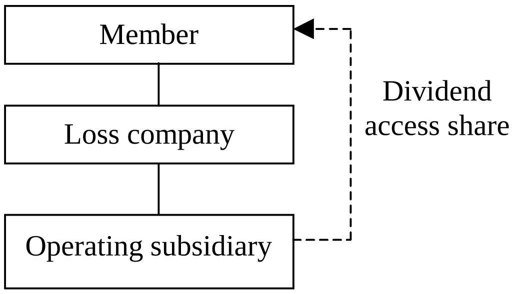
Example 7.8: Share buy back – excess credits

A corporate tax entity has ‘excess’ franking credits – that is, more franking credits than it is reasonably likely to use to frank its ordinary distributions. It buys back shares off-market predominantly from members most able to benefit from imputation credits because the terms of the buy-back are not attractive to the other members. As a result of the buy-back it uses profits it would not normally distribute, thereby directing a large franked distribution predominantly to those who benefit most from imputation credits.

This would be streaming. In this case avoiding wastage of franking credits is not a matter of concentrating scarce credits – there may well be sufficient credits to frank distributions to other members. (This type of arrangement may result in a proportionately greater interest in the corporate tax entity being held by members less able to benefit from imputation credits, and a value shift in favour of the shares not bought back. In these cases the remarks in paragraph 7.128 concerning deferral strategies may also be applicable.)

Example 7.9: Dividend access share

A company group contains an operating subsidiary which is owned by a loss company (i.e. a company that has tax losses). The members of the loss company can, because they are not in tax loss, derive a greater benefit from imputation credits than the loss company. The members are issued with a dividend access share (broadly speaking, a share which confers no rights, and is issued only to enable a taxpayer to get a distribution from the company – dividend access shares therefore frequently feature in streaming arrangements). The dividend access share is used to stream dividends directly to them.



This is another illustration of more sophisticated streaming. In cases such as these there will rarely be any distribution flowing to the member less able to benefit from the imputation credit.

7.129 It is necessary to distinguish cases where individual members have no effective interest in the profits of a corporate tax entity from the foregoing examples of 'single distribution' streaming.

7.130 In most cases the members less able to benefit from imputation credits have a real interest in the undistributed profits of the corporate tax entity, although the entity may not have yet allocated those profits to the members. However, some corporate tax entities have membership interests where the rights of the members holding those interests are effectively discretionary, since the entity can make distributions to some members to the exclusion of other members at its discretion. In these entities, which are usually family companies or trusts, the members do not have anything, in a sense relevant for streaming purposes, resembling a definite interest in the profits of the corporate tax entity, they have only a possibility of being considered as a possible recipient of distributions.

7.131 In these cases, the receipt of a franked distribution by one class of members does not imply that the other classes of members who have not received a franked distribution have deferred distribution of their share in the profits. More commonly it is reasonable to assume that they have simply missed out on any share in the profits. This is not streaming; all members with an actual share of the profits have appropriately received franked distributions.

7.132 In general, therefore, the distribution of franked and unfranked distributions by a closely-held family company or trust among family members is unlikely to be streaming.

What is an imputation benefit?

7.133 For streaming to occur, a member better able to benefit from imputation credits ('the targeted recipient') must receive one or more imputation benefits. An ***imputation benefit*** is:

- an entitlement to a tax offset or, if the member is a corporate tax entity, a franking credit;
- an exempting credit (these are basically franking credits of corporate tax entities that were formerly effectively wholly-owned by non-residents – restrictions are placed on their use);
- an imputation credit included in assessable income (this is relevant for members that are partnerships, or trustees of a trust not covered by the non-fixed trust regime that are not corporate unit trusts or public trading trusts); or
- an exemption from withholding tax (relevant if the member is a non-resident).

[Schedule 2, item 1, subsection 160-87(4)]

When does a member derive a greater benefit from imputation credits?

7.134 For this streaming rule to apply, the targeted recipient must:

- receive an imputation benefit; and
- because of the nature or status of the targeted recipient, derive a greater benefit from imputation credits than another member who misses out on an imputation benefit.

7.135 Relevant factors in determining whether the targeted recipient, derives a greater benefit from imputation credits than another member include:

- the residency of the members (non-residents cannot fully use imputation credits) ***[Schedule 2, item 1, paragraph 160-87(6)(a)]***;

- whether one of the members would not gain the full benefit of the tax offset from the franking credit (e.g. corporate tax entities are not entitled to a refund of excess imputation credits) ***[Schedule 2, item 1, paragraph 160-87(6)(b)]***;

- if one of the members is a corporate tax entity, whether it would be unable to make a franked distribution to its members (and therefore would be unable to distribute the franking credits it has received) ***[Schedule 2, item 1, paragraphs 160-87(6)(c) and (d)]***;

- if one of the members is a corporate tax entity, whether it would not be entitled to franking credits (e.g. because it is a mutual life insurance company) ***[Schedule 2, item 1, paragraph 160-87(5)(e)]***; and

- whether one of the members is able to benefit from franked distributions from corporate tax entities within the exempting entity regime (which covers entities effectively wholly-owned by non-residents or tax exempts) ***[Schedule 2, item 1, subsection 160-87(7)]***.

7.136 A difference in marginal tax rates of members of a corporate tax entity does not, by itself, indicate that some members derive a greater benefit from imputation credits than others.

<u>Commissioner's determination</u>

7.137 If the elements of this streaming rule are present, the Commissioner may make a determination that:

- the streaming entity will incur an additional franking debit in respect of each distribution made or other benefit received by a member; and/or

- no imputation benefit is to arise in respect of any streamed distributions paid to a member.

[Schedule 2, item 1, subsection 160-87(3)]

7.138 The determination made by the Commissioner can be revoked or varied and can be made at any time after the streaming has occurred.

7.139 Where it is decided to make a determination, generally speaking it could be expected that a determination will be made to impose a franking debit, rather than to remove imputation benefits, especially where there are numerous members. Where the Commissioner determines that the entity is to incur an additional franking debit, that debit is calculated as discussed in the paragraphs 7.147 to 7.149.

7.140 Where, however, *excess* franking credits are being streamed it will usually be appropriate to remove the imputation benefit from the members, because imposing a franking debit on the corporate tax entity may not effectively counteract the streaming arrangement if the entity retains a significant surplus of franking credits. Also, these are likely to be cases where there will be no other distribution, or equivalent benefit, in respect of which a franking debit could be calculated.

7.141 To give effect to the determination, the Commissioner is required to serve notice of the determination in writing on the taxpayer to which it relates. The notice may be included in a notice of assessment or served separately. ***[Schedule 2, item 1, subsections 160-89(2) and (4)]***

7.142 Where the Commissioner makes a determination that no imputation benefit is to arise and the determination applies in respect of a distribution made by a widely-held entity, the Commissioner will be able to satisfy the requirement of serving the notice of determination in writing on the taxpayer by publishing the notice in an Australian national newspaper. The notice is taken to have been served on the day that it is published. ***[Schedule 2, item 1, subsection 160-89(3)]***

7.143 A taxpayer dissatisfied with a determination will have the same rights of review and appeal as if the determination were an assessment ***[Schedule 2, item 1, section 160-90]***. However, to ensure that a determination carries its own rights of appeal a determination will not form part of an assessment ***[Schedule 2, item 1, subsection 160-89(1)]***.

<u>Bonus shares</u>

7.144 When the Commissioner is considering whether and how to exercise the discretion to make a determination, it is relevant to consider the effect of other provisions of the Act, as well as the differing effects of imposing a franking debit or removing a franking credit benefit.

7.145 For example, certain bonus share plans offer shareholders a choice between bonus shares or franked dividends (usually because some shareholders have pre-CGT shares and therefore a tax preference for capital). Under section 160-86A (explained above in paragraphs 7.115 to 7.119) an automatic franking debit arises to the entity in these cases.

7.146 In cases where the shareholders with pre-CGT shares are also disadvantaged shareholders, section 160-87 may apply if the bonus share plan was also part of a strategy to direct franked dividends to advantaged shareholders. However, if section 160-86A already applies to give the entity a franking debit, it would only be appropriate in rare cases for the Commissioner to make a determination to remove the imputation benefit from the pre-CGT shareholders who receive bonus shares.

How is the additional franking debit calculated?

7.147 If the streaming involves the making of distributions only, the additional franking debit is equal to the difference between:

- the amount of the franking credit (if any) allocated to the distribution paid to those members who do not derive as great a benefit from imputation credits as others; and
- the amount of the franking credit that would have been allocated to the distribution if the distribution had been franked to the same extent as the streamed distribution made to the members who benefit most from imputation credits.

[Schedule 2, item 1, subsection 160-88(2)]

7.148 If the streaming arrangement involves the streaming of more than one distribution to the members who benefit most from imputation credits, it is the extent to which the maximum franked distribution is franked (i.e. the distribution with the greatest franking percentage) that is relevant in determining the additional franking debit. For example, suppose during consecutive franking periods a company streams:

- two franked dividends to a shareholder, one of which is franked to the extent of 60% and the other franked to the extent of 80%; and
- one unfranked distribution to another shareholder.

The additional franking debit that could arise in relation to the unfranked distribution is the amount of the franking debit that would have arisen if it had been franked to 80%.

7.149 If the streaming involves the making of distributions and the provision of other benefits, the additional franking debit is equal to the franking debit that would have arisen if a distribution equal to the value of the benefit had been franked at 100%. ***[Schedule 2, item 1, paragraph 160-87(3)(b)]***

What information must a corporate tax entity give to its members when it makes a franked distribution?

7.150 A corporate tax entity that makes a frankable distribution must provide the recipient member with a distribution statement that contains certain information about the entity and the distribution. ***[Schedule 2, item 1, section 160-95]***

7.151 The statement may be given before the distribution is made, but must be given no later than 3 months after it is made. ***[Schedule 2, item 1, subsections 160-95(2) and (3)]***

Form of the distribution statement

7.152 The distribution statement must be in the approved form, which will be set out in guidelines issued by the Commissioner. Pending the issue of these guidelines, a distribution statement will be taken to comply with the approved form if it meets all the requirements specified in paragraph 7.153. ***[Schedule 2, item 1, subsection 160-100(2)]***

7.153 The distribution statement must contain the following information:

- the identity of the entity making the distribution;
- the date on which the benefit comprising the distribution is made;
- the total amount of the frankable distribution;
- the franking percentage of the distribution;
- the imputation credit from the distribution (this will ordinarily be the franking credit allocated to it, unless the franking percentage is greater than 100% – see paragraphs 7.57 to 7.58);
- the amount of any dividend withholding tax that has been deducted from the distribution; and
- any other information required by the approved form.

[Schedule 2, item 1, subsection 160-100(3)]

Failure to give a distribution statement or giving a misleading statement

7.154 The TAA 1953 will provide penalties for failing to provide a distribution statement in the approved form or for making a misleading statement in connection with a franked distribution.

How do franking credits and franking debits arise?

7.155 The rules relating to franking accounts are set out in Subdivision 160-F. These rules essentially replicate the rules relating to franking credits and debits in the current law.

7.156 In summary, franking credits will arise upon payment of income tax and PAYG instalments, and receipt of franked distributions. Franking debits will arise upon payment of franked distributions, and refunds of income tax and PAYG instalments. Franking deficit tax will be imposed if a franking account is in deficit at the end of the income year (i.e. if the sum of the franking debits in the franking account exceeds the sum of the franking credits), and cannot be offset against income tax. ***[Schedule 2, item 1, section 160-135]***

7.157 The franking account rules apply to all corporate tax entities rather than only to franking entities. A corporate tax entity that is not a franking entity will incur a liability for franking deficit tax if it purports to make a franked distribution (this is explained in more detail in paragraph 7.168). However, franking credits or debits will not otherwise arise for corporate tax entities that are not franking entities and, unless they purport to make a franked distribution, for practical purposes, these entities can disregard the franking account rules. ***[Schedule 2, item 1, section 160-110]***

7.158 Franking credits for payment of PAYG instalments and corporate tax, and franking debits for refunds of corporate tax, arise only for resident entities. The residency criteria are contained in the 'sufficiently resident' test, which is carried over from the current law.

7.159 The franking account will be a rolling balance account rather than a yearly one with an annual balance transfer. This is a simplification measure that removes the need for a franking credit to effect the transfer of a credit balance to the following income year.

Franking credits

7.160 The circumstances in which a franking credit will arise are set out in the table in section 160-115. These circumstances are discussed in paragraphs 7.161 to 7.165.

Payment of a PAYG instalment or income tax

7.161 Payment of a PAYG instalment or income tax will give rise to a franking credit. The amount of the franking credit is reduced on an attribution basis if an entity is not a franking entity for the whole of the relevant instalment period in the case of PAYG instalments, or for the whole of the relevant income year in the case of corporate tax. ***[Schedule 2, item 1, section 160-115, items 1 to 4 in the table]***

7.162 Section 160-120 explains when a corporate tax entity is taken to have paid a PAYG instalment or income tax for the purpose of the imputation rules. This replicates section 160APBB of the ITAA 1936. ***[Schedule 2, item 1, section 160-120]***

Receipt of a franked distribution

7.163 Receipt of a franked distribution will also generally give rise to a franking credit. The franking credit equals the imputation credit on the distribution. ***[Schedule 2, item 1, section 160-115, item 5 in the table]***

Liability for franking deficit tax

7.164 A franking credit will arise if an entity incurs a liability for franking deficit tax. Section 160-135 explains when an entity's franking account is in deficit. The credit is triggered by liability for, rather than payment of, franking deficit tax to avoid the possibility of franking deficit tax being imposed in respect of outstanding franking deficit tax incurred for an earlier income year. Although a franking credit does not arise under the current law for a liability to pay franking deficit tax, in effect the same outcome is achieved because a franking deficit is not carried over to the following year. ***[Schedule 2, item 1, section 160-115, item 6 in the table]***

Foreign withholding tax paid on a distribution

7.165 The franking credits that arise for foreign withholding tax paid on a distribution received by an entity are explained in Chapter 8. ***[Schedule 2, item 1, section 160-115, items 7 and 8 in the table]***

Franking debits

7.166 The circumstances in which a franking debit will arise are set out in the table in section 160-130. These circumstances are discussed in the following paragraphs.

Making a franked distribution

7.167 A franking debit arises if a franking entity makes a franked distribution.

7.168 A franking debit also arises if a corporate tax entity that is not a franking entity purports to frank a distribution. This debit would result in the entity becoming liable to pay franking deficit tax because, not being a franking entity, it would not be able to obtain franking credits to offset the debit. However, no imputation credits would arise for the recipient of the distribution in this case because it would not be a franked distribution (only franking entities can make franked distributions). ***[Schedule 2, item 1, section 160-130, item 1 in the table]***

7.169 The debit for making a distribution arises at the time the distribution is made.

Refund of income tax

7.170 A franking debit will arise if an entity receives a refund of income tax. The amount of the franking debit is reduced on an attribution basis if an entity is not a franking entity for the whole of the relevant income year. ***[Schedule 2, item 1, section 160-130, items 2 and 3 in the table]***

7.171 The relevant parts of section 160APBD of the ITAA 1936 are replicated to provide when a refund of income tax is received. ***[Schedule 2, item 1, section 160-125]***

Underfranked distributions

7.172 A franking debit will arise if an entity makes an underfranked distribution, that is, a distribution with a franking percentage that is less than the entity's benchmark franking percentage for the franking period. This debit is explained in more detail in paragraphs 7.80 to 7.81 in the context of the benchmark rules. ***[Schedule 2, item 1, section 160-130, item 4 in the table]***

Ceasing to be a franking entity

7.173 If an entity ceases to be a franking entity, a franking debit will arise to eliminate any franking surplus. The debit will ordinarily arise at the time the entity ceases to be a franking entity. ***[Schedule 2, item 1, section 160-130, item 5 in the table]***

Linked distribution

7.174 A franking debit will arise if an entity makes a linked distribution. This debit is explained in more detail in the context of the anti-streaming rules in paragraphs 7.108 to 7.112. ***[Schedule 2, item 6, section 160-130, item 7 in the table]***

Tax-exempt bonus shares

7.175 A franking debit will arise if an entity issues tax-exempt bonus shares instead of making a distribution. This debit is explained in more detail in the context of the anti-streaming rules in paragraphs 7.115 to 7.119. ***[Schedule 2, item 1, section 160-130, item 8 in the table]***

Streaming determination

7.176 A franking debit will also arise if the Commissioner makes a determination that a franking debit should arise because the entity is streaming imputation benefits to members most able to benefit from them. This debit is explained in more detail in the context of the anti-streaming rules in paragraphs 7.147 to 7.149. ***[Schedule 2, item 1, section 160-130, item 7 in the table]***

Division 7A and Subdivision 156-C distributions

7.177 Consistent with the current law, a franking debit arises if an entity is taken to have paid a distribution under Division 7A of Part III of the ITAA 1936 or its equivalent for non-fixed trusts (Subdivision 156-C, except for sections 156-92 and 156-94). The debit is equal to the debit that would have arisen had the amount of the distribution been a frankable distribution franked to the entity’s benchmark franking percentage for the franking period in which the distribution is taken to have been made (or franked at 100% if there is no benchmark). This ensures that no benefits are available by streaming unfrankable distributions to certain members. ***[Schedule 2, item 1, section 160-130, items 9 and 10 in the table]***

On-market buy-backs

7.178 Also consistent with the existing law, a franking debit arises if a company buys back a share on-market. The debit is equal to the debit that would have arisen had the buy-back been off-market. Again, this prevents streaming by companies buying back some shares off-market (giving rise to a frankable dividend) and other shares on-market (which results in no dividend). ***[Schedule 2, item 1, section 160-130, item 11 in the table]***

Franking deficit tax

7.179 If a corporate tax entity has a deficit in its franking account at the end of an income year, it has imputed to its members more tax than it has paid. In these circumstances it needs to pay franking deficit tax to account for the over-imputation of tax.

7.180 An entity will be liable to pay franking deficit tax if its franking account is in deficit at the end of an income year or, if it ceases to be a franking entity, when it ceases to be a franking entity ***[Schedule 2, item 1, section 160-140]***. Subsection 160-135(2) explains when an entity's franking account is in deficit.

7.181 Franking deficit tax cannot be offset against income tax. This is in recognition of the greater access to imputation benefits through refunding excess imputation credits, and to prevent the reinstatement of tax preferences.

7.182 If a franking deficit would have arisen but does not because of a payment of tax that is refunded in the following year (within 3 months of the end of the previous year), the refund that arises in the following year will be treated for the purpose of franking deficit tax as though it had been paid at the end of the preceding income year. This will result in a recalculation of franking deficit tax. The franking deficit tax, or additional amount of franking deficit tax, is payable within 14 days of the day the refund is paid or such later day as set by the ITAA 1997. ***[Schedule 2, item 1, section 160-145]***

7.183 This rule is a disincentive for an entity that might overpay tax to avoid franking deficit tax. The rule achieves the same outcome as the deficit deferral tax that is imposed under the current law, but removes the need for a separate tax.

7.184 Additional franking deficit tax of 30% will be imposed where an entity's franking deficit is more than 10% greater than the total of the franking credits arising during the relevant income year. This additional tax will be imposed under subsection 5(2) of the New Business Tax System (Franking Deficit Tax) Bill 2000. The Commissioner has the same discretion to remit additional franking deficit tax that exists under the current law. ***[Schedule 2, item 1, section 160-150]***

What are the tax consequences of receiving a franked distribution?

7.185 If a corporate tax entity makes a franked distribution to a member there may be tax consequences for the recipient and:

- if the recipient is a partnership – a partner in the partnership;
- if the recipient is a trust not covered by the non-fixed trust regime – a beneficiary (or object) of the trust; and

- if the membership interest in respect of which the distribution is made is subject to a *cum-dividend* contract or securities lending arrangement – the purchaser or lender of the interest respectively.

7.186 The tax consequences for the member and the purchaser under a *cum dividend* contract or lender under a securities lending arrangement are addressed below. The tax consequences for a partner, or a beneficiary of a trust not covered by the non-fixed trust regime will be dealt with in a subsequent Bill.

The tax consequences for the member

7.187 The recipient of a franked distribution will, as a member of the entity, generally:

- gross-up the amount of the distribution to reflect the before-tax profit of the corporate tax entity - that is, the amount of the distribution plus the attached franking credit (called an imputation credit in the hands of the recipient); and

- receive a tax offset (formerly called a franking rebate) for the imputation credit.

7.188 These consequences occur if the conditions specified in section 161-210 are satisfied. Thus that section is the gateway provision for determining access to franking benefits. ***[Schedule 2, item 1, section 161-210]***

Grossing up the distribution

7.189 The general rule is that recipients of a franked distribution must include in their assessable income the amount of the distribution plus an additional amount, namely the franking credit allocated to it (to the extent that the amount allocated does not exceed the maximum credit that could be allocated to a distribution). The additional amount is referred to as the 'imputation credit', and the total of the distribution and imputation credit is referred to as the grossed-up amount of the distribution. In essence, the grossed-up amount of the distribution represents the before tax profits of the corporate tax entity that are being distributed. ***[Schedule 2, item 1, subsection 161-215(1)]***

7.190 There are some exceptions to this general rule:

- non-residents (other than a trust not covered by the non-fixed trust regime and partnerships) do not gross-up the distribution – they simply receive an exemption from withholding tax on that part of the distribution which is franked ***[Schedule 2, item 1, subsection 161-210(2)]***;

- no gross-up occurs if an anti-avoidance rule is triggered because the distribution is made under a dividend stripping, franking credit trading or dividend streaming scheme ***[Schedule 2, item 1, subsection 161-210(4)]***; and

- if the distribution is exempt income in the recipient's hands, the imputation credit is not included in assessable income ***[Schedule 2, item 1, subsection 161-210(3)]***.

Offsetting the tax on the gross-up distribution

7.191 Having grossed up the distribution by including the imputation credit in assessable income, most recipients are then entitled to a tax offset. This offset is the amount of the imputation credit. ***[Schedule 2, item 1, section 161-220]***

7.192 Again, this is subject to the non-resident exception and the application of the anti-avoidance rules referred to in paragraphs 7.120 to 7.149. Also, trusts not covered by the non-fixed trust regime, and partnerships, do not obtain a tax offset (assuming, in the case of a trust, the trustee is not assessed on the distribution) – instead their beneficiaries or partners may be entitled to it. If the trustee is assessed on the distribution, then the offset can be claimed by the trustee.

7.193 In certain cases, notwithstanding that the distribution is exempt income, the offset is allowed. This is the case for registered charities and gift deductible organisations who are entitled to a refund of the offset, and certain types of income relating to superannuation and life insurance. ***[Schedule 2, item 1, subparagraphs 161-210(4)(a)(ii) and (iii)]***

7.194 If the tax offset exceeds the total tax payable by the recipient, the excess is generally refundable except for corporate tax entity recipients. The rules for providing refunds of excess imputation credits under the new imputation system will be included in a later Bill.

7.195 In addition to the tax offset, resident corporate tax entities receive a franking credit (unless they are not franking entities at the time of receipt – see paragraph 7.163).

Recipients other than members

7.196 The consequences explained in paragraphs 7.187 to 7.195 apply in relation to franked distributions received directly from a corporate tax entity. It is also possible to receive an indirect distribution through a flow-through entity (i.e. a trust not covered by the non-fixed trust regime or a partnership), as a purchaser of a membership interest *cum-dividend*, or as a lender in a securities lending arrangement (see paragraphs 7.198 to 7.199).

7.197 The tax treatment of the receipt of an indirect distribution will be addressed in a later Bill. Broadly speaking, the provisions addressing indirect distributions will essentially replicate the existing law in Division 7 of Part IIIAA of the ITAA 1936.

The tax consequences for cum-dividend contracts or securities lending arrangements

7.198 The current arrangements for *cum-dividend* contracts (i.e. a sale of shares or units in certain trusts under terms that require transfer of a declared dividend or distribution to be passed on to the buyer) and securities lending arrangements will remain. Therefore:

- the purchaser of a membership interest bought on-market *cum-dividend* after the books closing date for the distribution will be treated as having received the distribution directly from the corporate tax entity as a member (with all the franking consequences that entails) ***[Schedule 2, item 1, section 160-100B]***; and
- the lender of shares under a securities lending arrangement who receives a distribution paid on the shares from the borrower will also be treated as having received the distribution directly from the corporate tax entity ***[Schedule 2, item 1, section 160-100C].***

7.199 Consistent with the current law, the relevant parties to these arrangements need to provide the counter-party with sufficient information for that party to determine the imputation consequences of the distribution. ***[Schedule 2, item 1, sections 160-102 to 160-104]***

Application and transitional provisions

7.200 The application and transitional provisions in relation to this measure will be included in a later Bill.

Consequential amendments

7.201 The consequential amendments in relation to this measure will be included in a later Bill.

Chapter 8
Franking credits for foreign withholding tax

Outline of Chapter

8.1 This Chapter explains Schedule 2 to this exposure draft which inserts new Subdivision 160-G into the ITAA 1997.

8.2 Subdivision 160-G reduces the taxation disparity that presently exists between equity investments by Australian residents made directly in foreign corporate tax entities and those made indirectly through Australian corporate tax entities. Bringing the treatment of these investments closer together will reduce the disincentive for foreign corporate tax entities to distribute profits to Australian residents. It will also partially remove a current bias against foreign investment over domestic investment. The Subdivision achieves this objective by allowing Australian corporate tax entities franking credits for withholding tax withheld on foreign distributions equivalent to frankable distributions up to 15% of the gross distributions received.

Context of reform

8.3 An Australian entity investing directly in a foreign corporate tax entity is entitled to a credit against Australian tax for foreign withholding tax paid on repatriated profits. However, if the same investment were made through an interposed Australian corporate tax entity, foreign profits repatriated through the Australian interposed entity would be received as unfranked distributions and bear an additional layer of tax in the hands of the Australian individual investor.

8.4 The Review considered that the disparity in taxation treatment could discourage the making of offshore investments. This was viewed as not in Australia's best interest, in the light of increased opportunities to invest profitably offshore and a growing number of Australian businesses that are expanding offshore (see *A Tax System Redesigned*, pages 627-629). The Review recommended bringing the tax treatment of direct and indirect equity investments in foreign corporate tax entities closer together. It recommended doing this by allowing imputation credits for foreign withholding tax up to a maximum of 15% of dividends received (see recommendation 20.1).

8.5 This Chapter explains the measures that give effect to the principle reflected in recommendation 20.1 of *A Tax System Redesigned*.

Summary of new law

8.6 The new law will allow Australian corporate tax entities that receive foreign distributions equivalent to frankable distributions to claim credits in their franking accounts for withholding tax paid on those distributions. The amount of the credit will be the lesser of the actual withholding tax paid and 15% of the gross distribution equivalent to a frankable distribution. A further franking credit may be allowed to a corporate tax entity if withholding tax on a foreign distribution equivalent to a frankable distribution it receives is less than 15% of the gross distribution and withholding tax was paid by its wholly-owned non-resident subsidiaries (foreign 100% subsidiaries) on foreign distributions equivalent to frankable distributions they received.

Comparison of key features of new law and current law

New law	***Current law***
A franking credit, up to 15% of a gross distribution received by an Australian corporate tax entity, will be available for foreign withholding tax paid on foreign distributions equivalent to frankable distributions repatriated to Australia.	There is no equivalent rule in the existing law.
An Australian corporate tax entity entitled to a franking credit of less than 15% of a foreign distributions equivalent to a frankable distribution received from a foreign *100% subsidiary* will, in certain circumstances, be allowed to top up its franking credit to 15% of the gross distribution equivalent to a frankable distribution received. The amount of the top-up is calculated by reference to withholding tax paid on prior distributions equivalent to frankable distributions which pass through foreign 100% subsidiaries.	There is no equivalent rule in the existing law.

Detailed explanation of new law

Terminology

8.7 There are 2 sections in this Subdivision that deal with franking credits for foreign withholding tax – one explains the general rule and the other the top-up rule. Each section introduces a number of new terms which are described briefly in paragraphs 8.8 to 8.12 and are more fully described under the explanation of each rule.

8.8 A franking credit under the general rule arises in the franking account of an *Australian corporate tax entity* (a resident of Australia) when *foreign tax is withheld* on a *distribution equivalent to a frankable distribution* made to it by a *foreign corporate tax entity* (a non-resident of Australia). Foreign tax withheld is eligible only to the extent that it is attributable to that part of a distribution equivalent to a frankable distribution and is not the subject of some compensation scheme in the country from which the distribution is made (the *reduced withholding tax)*. A franking credit arises on the day that foreign tax withheld is paid and will be for an amount equal to the lesser of the reduced withholding tax or 15% of the gross amount of a distribution equivalent to a frankable distribution. ***[Schedule 2, item 1, section 160-160]***

8.9 Under section 160-165, an Australian corporate tax entity may top up a franking credit calculated under the general rule if it receives a distribution equivalent to a frankable distribution from a foreign 100% subsidiary (the *key distribution*). A 100% subsidiary is a non-resident corporate tax entity that is wholly-owned, directly or indirectly, by the Australian corporate tax entity. This rule only applies if the amount of tax withheld on the key distribution is less than 15%.

8.10 Where the preconditions are satisfied, the Australian entity will need to identify all its foreign 100% subsidiaries that relate to the key distribution. These form a *chain of entities*. All members in the chain of entities that receive a distribution equivalent to a frankable distribution (a distribution from another foreign corporate tax entity) and which make a *flow-on distribution* to another member in the chain will be eligible to calculate a *withholding tax credit* using a prescribed formula. All distributions received and made must take place within a period of 12 months ending either on the day a franking credit arises under the general rule or on the day on which the key distribution is made (the *chain of entities test period).*

8.11 A withholding tax credit may be a fraction of the withholding tax paid on a distribution equivalent to a frankable distribution received from a foreign corporate tax entity. As for the general rule, that withholding tax must first be reduced to the extent that it exceeds 15% of the distribution equivalent to a frankable distribution and by any entitlements under a compensation scheme of the country from which the distribution is made (the *adjusted withholding tax on a prior equivalent foreign distribution*). The fraction is the ratio that the amount of flow-on distribution made bears to the amount of distribution received before the entity makes the flow-on distribution (the *prior foreign distribution equivalent to a frankable distribution*) after deducting tax that was withheld and *expenses relating to a prior equivalent foreign distribution* (expenses incurred in obtaining the prior foreign distribution). This is detailed in the formula in paragraph 8.46.

8.12 A top-up amount is so much of one or more withholding tax credits that it takes to increase a franking credit calculated under the general rule to 15% of the key distribution received by the Australian corporate tax entity.

Franking credits for foreign withholding tax – general rule

8.13 An Australian corporate tax entity may be allowed a franking credit for foreign withholding tax paid in respect of a distribution it receives from a non-resident corporate tax entity. The distribution may be from a portfolio interest (i.e. a membership interest of less than 10%) or non-portfolio interest in the non-resident entity and may be exempt from Australian tax (e.g. under section 23AJ of the ITAA 1936 which provides an exemption for certain non-portfolio dividends). ***[Schedule 2, item 1, subsection 160-160(1)]***

8.14 To qualify for a franking credit, an Australian corporate tax entity that receives a distribution equivalent to a frankable distribution from a foreign corporate tax entity, that is, it is a non-resident at the time the distribution is made ***[Schedule 2, item 1, paragraph 160-160(1)(a)]*** must be:

- a member of the foreign corporate tax entity at the time a distribution is made ***[Schedule 2, item 1, paragraph 160-160(1)(b)]***;
- a qualified person in relation to the distribution, that is, the entity qualifies for imputation benefits under the franking credit trading rules ***[Schedule 2, item 1, paragraph 160-160(1)(c)]***;
- sufficiently resident in the income year in which the distribution is received ***[Schedule 2, item 1, paragraph 160-160(1)(d)]***; and
- personally liable for the withholding tax paid on the foreign distribution received ***[Schedule 2, item 1, paragraph 160-160(1)(e) and subsection 160-160(4)]***.

8.15 The term 'frankable distribution' is defined in subsection 995-1(1) and applies to the imputation system generally.

8.16 Franking credits will only arise from withholding tax levied on distributions equivalent to frankable distributions made by non-resident corporate tax entities. ***[Schedule 2, item 1, subsection 160-160(1)]***

What is a foreign distribution equivalent to a frankable distribution?

8.17 A distribution **equivalent to a frankable distribution** is a foreign distribution that would be a frankable distribution for Australian income tax law purposes if it had been made by an Australian corporate tax entity and the distribution is made by a corporate tax entity that is a non-resident of Australia at the time the distribution is made. ***[Schedule 2, item 1, subsection 160-160(2)]***

8.18 The term 'distribution equivalent to a frankable distribution' applies to both the general and top-up rules.

How to work out the amount of the franking credit

8.19 Subsection 160-160(6) provides a method statement for calculating the amount of the franking credit. The method statement explains the order in which 3 factors that may affect an amount of withholding tax need to be taken into account in determining a franking credit. ***[Schedule 2, item 1, subsection 160-160(6)***

8.20 The first factor that may affect the amount of a franking credit is the composition of the distribution. Where a distribution is comprised of a mixture of a frankable portion (e.g. profits) and an unfrankable portion, such as, a return of contributed capital (a composite distribution), only the withholding tax attributable to that part of the distribution which is equivalent to a frankable distribution can be used in the calculation of a franking credit. Generally, the withholding tax would be apportioned in the same ratio as the distribution equivalent to a frankable distribution is to the whole distribution.

8.21 However, an apportionment is not necessary where the portion of a distribution equivalent to a frankable distribution is the same under both the taxation laws of Australia and another country. For example, an Australian corporate tax entity that receives a composite distribution from a country which imposes withholding tax only on that portion that is equivalent to a frankable distribution would, subject to conditions, be entitled to a franking credit equal to the amount of the withholding tax because all of the withholding tax is attributable to the distribution equivalent to a frankable distribution. If the portion of the distribution equivalent to a frankable distribution under Australian taxation law differs from that determined under the taxation law of another country, the franking credit could be the fraction of the withholding tax that the amount of distribution equivalent to a frankable distribution determined under Australian law bears to the amount of the distribution from profits determined under the taxation law of the other country. A franking credit greater than the amount of withholding tax paid is not allowable.

8.22 The second factor affects the amount of withholding tax which can give rise to a franking credit. The amount of withholding tax is reduced to the extent that the country from which the distribution is made (the source country) provides any benefits that relate to the making of distributions, or to foreign withholding tax paid on distributions made, to Australian corporate tax entities (compensation schemes). Compensation schemes under which benefits are provided by source countries may take many forms and all benefits are to be taken into account regardless of the form the scheme takes. Benefits provided to associates of foreign corporate tax entities or their members are also to be taken into account. Examples of benefits include a lower effective rate of underlying tax on profits, the receipt of a rebate of tax or imputation credit, and a refund of some or all of the foreign withholding tax paid to which an Australian resident recipient becomes entitled.

8.23 The third factor restricts the amount of the franking credit to 15% of the amount of a distribution equivalent to a frankable distribution.

8.24 The 15% limit applies to withholding tax paid on each distribution equivalent to a frankable distribution. The amount of any withholding tax in relation to a distribution equivalent to a frankable distribution which exceeds 15% will be lost under these provisions and cannot be carried forward to a later period. Equally, the withholding tax rate cannot be an average of rates at which tax was withheld on a number of foreign distributions equivalent to frankable distributions.

8.25 Applying the above factors in a different order may produce inappropriate results, for example, applying the 15% limit first may result in no withholding tax remaining after deducting the amount of a benefit entitlement under a compensation scheme even though there was withholding tax in excess of 15%. The order prescribed in the method statement avoids this kind of result.

Example 8.1: Applying the method statement

This example shows how to use the method statement in subsection 160-160(6) to calculate the franking credit arising in the following scenario:

Gross distribution = $1,000

Withholding tax rate = 30%

Amount of withholding tax paid = $300

Assume 90% of the distribution ($900) is equivalent to a frankable distribution and the Australian corporate tax entity is entitled to a refund of one-third ($100) of the withholding tax that was paid.

Step 1: Determine the amount of withholding tax that relates to the portion of the distribution equivalent to a frankable distribution.

90% of $300 = $270

Step 2: Determine the amount of withholding tax refund that relates to the portion of the distribution equivalent to a frankable distribution and which the foreign corporate tax entity making the distribution, or the Australian corporate tax entity, or any associate of either, is entitled to receive under a compensation scheme.

The amount of the refund that relates to the distribution equivalent to a frankable distribution is calculated as follows:

90% of $100 = $90

Step 3: The amount of the withholding tax calculated under step 1 is reduced by the amount calculated under step 2. The new amount is the 'reduced withholding tax' amount.

Reduce the step 1 amount by the step 2 amount:

$270 – $90 = $180 (reduced withholding tax)

Step 4: The franking credit is equal to the lesser of:

a) the reduced withholding tax, that is, $180; and

b) 15% of the part of the gross distribution equivalent to a frankable distribution, that is:

15% of $900 = $135

As (b) is less than (a), the franking credit amount is $135.

What happens if a distribution is characterised differently in Australia?

8.26 Generally, an amount withheld on a distribution under the law of a foreign country will attract a franking credit for the Australian corporate tax entity if the distribution is equivalent to a frankable distribution under Australian law. However, a benefit which is the subject of a withholding tax may be characterised differently under the taxation law of Australia and that of a foreign country. A franking credit arises only if the benefit received by the Australian corporate tax entity qualifies as a distribution equivalent to a frankable distribution under Australian taxation law.

When does the franking credit arise?

8.27 The Australian corporate tax entity will credit its franking account at the time the foreign withholding tax in relation to a particular distribution is paid. ***[Schedule 2, item 1, subsection 160-160(5)]***

What payments do not give rise to franking credits?

8.28 Franking credits will not be allowed for:

- tax sparing credits, as no withholding tax is paid;
- payments which, in substance, represent corporations tax paid in advance;
- withholding tax on distributions equivalent to frankable distributions received by an Australian corporate tax entity through foreign trusts or other conduit entities unless they are taxed as corporate entities in the foreign country and withholding tax is paid on distributions out of after-tax profits;
- withholding taxes on any payments unless the payments by foreign corporate tax entities to Australian corporate tax entities qualify as distributions equivalent to frankable distributions under Australian tax law (see paragraph 8.26); or
- withholding tax to the extent there is an entitlement under a compensation scheme (see paragraph 8.22).

Franking credits for foreign withholding tax – top-up rule

8.29 The general rule restricts a franking credit to the lesser of 15% of a gross distribution equivalent to a frankable distribution and the actual foreign withholding tax paid on the distribution.

8.30 However, an exception to this rule will apply when:

- an Australian corporate tax entity (Australian entity) receives a distribution equivalent to a frankable distribution from an entity that is a foreign entity (i.e. a non-resident corporate tax entity) at the time the distribution is made (the ‘key distribution’) ***[Schedule 2, item 1, paragraph 160-165(1)(a)]***;
- the Australian entity is sufficiently resident in the income year in which the key distribution is received ***[Schedule 2, item 1, paragraph 160-165(1)(b)]***;
- the Australian entity is a qualified person in relation to the key distribution ***[Schedule 2, item 1, paragraph 160-165(1)(c)]***;
- the Australian entity and the foreign entity are part of a chain of entities (e.g. the Australian entity directly or indirectly holds 100% of the membership interest in the foreign entity) at the time the key distribution is made ***[Schedule 2, item 1, paragraph 160-165(1)(d)]***;

- the franking credit for foreign withholding tax paid in relation to the distribution equivalent to a frankable distribution received by the Australian entity from the foreign entity is nil or less than 15% of the gross amount of the key distribution ***[Schedule 2, item 1, paragraph 160-165(1)(e)]***;

- a withholding tax credit arises for a foreign entity that is part of the chain of entities at the time the key distribution is made ***[Schedule 2, item 1, paragraph 160-165(1)(f)]***; and

- the withholding tax credit is neither a withholding tax credit that gave rise to a franking credit for the Australian entity under an earlier application of section 160-165 nor a withholding tax credit that would have (except for the legislative limitations) given rise to a franking credit or a greater franking credit for the Australian entity under an earlier application of that section ***[Schedule 2, item 1, paragraph 160-165(1)(g)]*** (see also paragraphs 8.53 and 8.54).

8.31 Similar to the general rule, the top-up rule applies only to the extent that the relevant distribution is equivalent to a frankable distribution.

8.32 Where the required conditions are satisfied, the Australian corporate tax entity can top up a franking credit determined under the general rule to a maximum of 15% of the gross distribution equivalent to a frankable distribution received from a foreign 100% subsidiary. The top-up amount will, broadly speaking, comprise a part or all of the withholding tax paid on distributions equivalent to frankable distributions received by the foreign 100% subsidiary from other foreign entities (not necessarily wholly-owned subsidiaries) before it made its distribution to the Australian entity.

8.33 The key aspects to this top-up rule are explained in paragraphs 8.34 to 8.56.

Top-up rule applies to each key distribution

8.34 Each distribution equivalent to a frankable distribution received by an Australian corporate tax entity from a foreign 100% subsidiary will be a key distribution. As a result, each key distribution will identify a chain of entities which may be a source of franking credits under the top-up rule.

A wholly-owned subsidiary is a 100% subsidiary?

8.35 The term '100% subsidiary' is defined in subsection 995-1(1) and the related section 975-505. For the purposes of the top-up rule, the term means:

- a foreign corporate tax entity that is a wholly-owned subsidiary of an Australian corporate tax entity or of one or more 100% subsidiaries; and
- a foreign corporate tax entity which is wholly-owned by the Australian entity and one or more 100% subsidiaries.

A foreign corporate tax entity in which an entity not mentioned above holds any membership interest will not qualify as a 100% subsidiary.

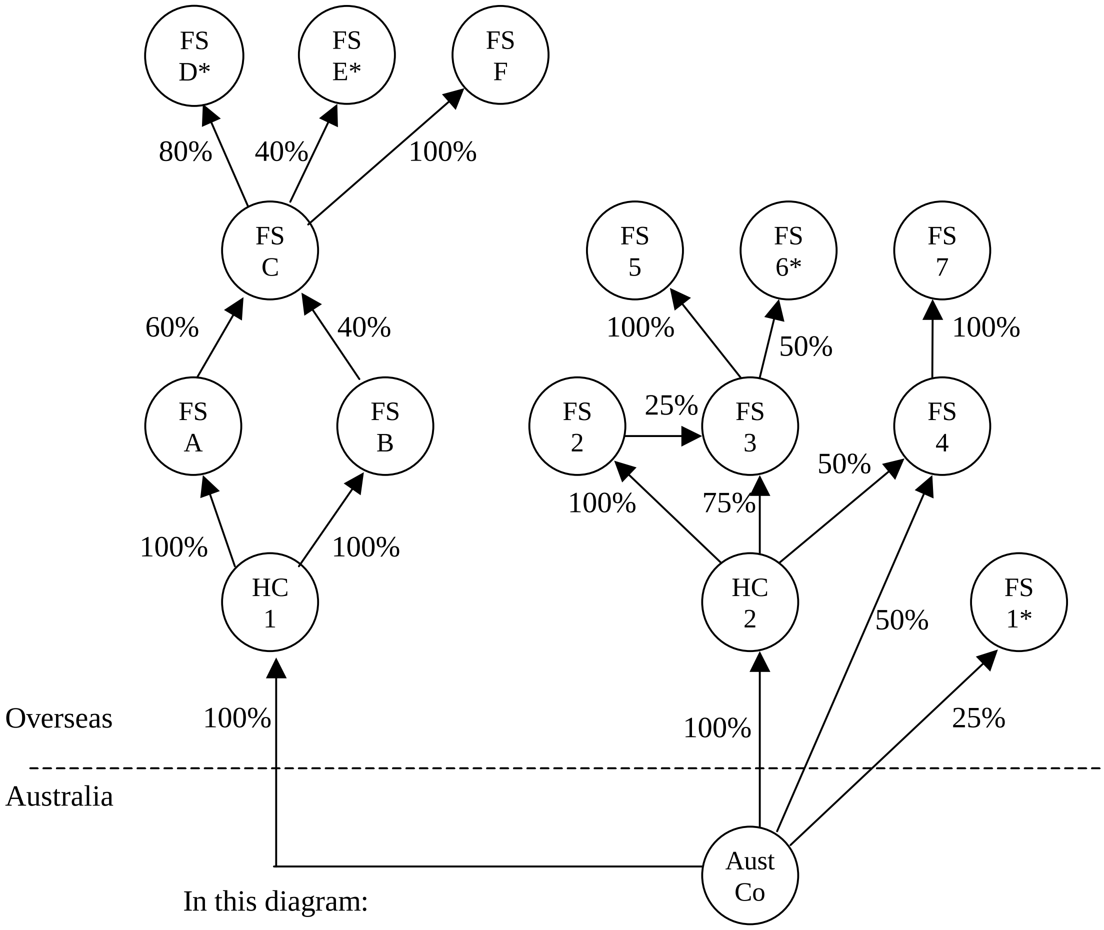
Section 975-505 of the ITAA 1997 needs to be made to apply to all corporate tax entities. Consequential amendments are to be made in a later Bill.

What is a chain of entities?

8.36 A chain of entities is determined at a particular point in time, that is, on the day on which a key distribution is made to an Australian corporate tax entity by a foreign 100% subsidiary in the chain. On that day, the Australian corporate tax entity and its foreign 100% subsidiaries will form a 'chain of entities'.

8.37 Diagram 8.1 illustrates different chains of entities.

Diagram 8.1: Chains of entities



In this diagram:

Aust Co represents an Australian company.

HC represents a foreign holding company.

FS represents a foreign subsidiary.

* The entities which are asterisked are not members of a chain of entities.

The 3 chains shown in the diagram are:

Chain 1 – Aust Co, HC 1, FS A, FS B, FS C and FS F.

Chain 2 – Aust Co, HC 2, FS 2, FS 3, FS4, FS 5 and FS7.

Chain 3 – Aust Co, FS 4 and FS 7.

What is a chain of entities test period?

8.38 This is a period of 12 months ending on either of 2 days. If a franking credit arises under the general rule, the chain of entities test period ends on the day that the franking credit arises. If no withholding tax is paid on a key distribution, the chain of entities test period ends on the day on which the key distribution is made. ***[Schedule 2, item 1, subsection 160-165(6)]***

Which entities in a chain can provide a top-up amount?

8.39 The corporate tax entities which may be sources for top-up amounts are described in subsection 160-170(1). These entities must all be foreign 100% subsidiaries.

8.40 The conditions that need to be satisfied before a foreign corporate tax entity can be a source for top-up amounts are:

- in the chain of entities test period (a 12 month period), a corporate tax entity (which, in the context of the section, is a foreign 100% subsidiary) receives a distribution equivalent to a frankable distribution from either another member in the chain of entities or a foreign corporate tax entity outside of that chain, for example, it may be a joint venture entity or an entity in which the receiving entity has a portfolio interest. ***[Schedule 2, item 1, paragraph 160-170(1)(a)]***. The distribution must be received before the key distribution is made ***[Schedule 2, item 1, paragraph 160-170(1)(b)]***;
- tax is withheld by the distributing corporate tax entity on the distribution equivalent to a frankable distribution made to the receiving foreign corporate tax entity ***[Schedule 2, item 1, paragraph 160-170(1)(c)]***;
- after receiving the foreign distribution, the foreign 100% subsidiary makes a distribution equivalent to a frankable distribution (described as a 'flow-on distribution') to another entity in the chain of entities *before* the key distribution is made to the Australian entity except where the flow-on distribution is the key distribution ***[Schedule 2, item 1, paragraph 160-170(1)(d)]***;
- each of the foreign 100% subsidiaries is either the entity making a distribution to the Australian entity or is linked by a series of distributions made through them during the chain of entities test period ***[Schedule 2, item 1, paragraph 160-170(1)(e)]***; and
- at all times during the period commencing at the beginning of the day on which the distribution equivalent to a frankable distribution is received and ending on the day on which the key distribution is made, all entities that have received and made distributions equivalent to frankable distributions are members of the same chain of entities ***[Schedule 2, item 1, paragraph 160-170(1)(f)].***

8.41 At the time that a top-up amount needs to be calculated, the above criteria are applied to each member of a chain of entities. The entities that meet the criteria must all have received and made distributions equivalent to frankable distributions in the chain of entities test period. Broadly, these entities may be said to be linked by a series of distributions beginning with a distribution equivalent to a frankable distribution to a member of the chain of entities and ending with the key distribution to the Australian corporate tax entity. The distributions must be within the time frame of the chain of entities test period. However, the actual period in which all distributions are made may be much shorter, for example, the period envisaged in the last dot point in paragraph 8.40 may be shorter than 12 months.

8.42 The foreign corporate tax entities which satisfy the criteria and which are linked by a series of distributions will be those for which 'withholding tax credits' (see paragraphs 8.45 to 8.50) may be calculated and those from which top-up franking credits may be drawn.

8.43 Also, as long as a series of distributions links a number of members in the chain of entities, withholding tax credits will not be denied because withholding tax was not deducted in one section of the chain. The condition contained in paragraph 160-170(1)(c), that tax be withheld by the entity making the foreign distribution equivalent to a frankable distribution, is a pre-condition to the creation of withholding tax credits. Therefore, if a corporate tax entity in the chain receives a distribution equivalent to a frankable distribution from another member in the chain and no withholding tax is deducted, a withholding tax credit cannot arise in the receiving entity. However, if that receiving entity has itself made a flow-on distribution to another member in the chain, in the chain of entities test period, it nonetheless provides access to any withholding tax credit in the entity above it that made the flow-on distribution to it.

Tracing of withholding tax credits

8.44 If the sum of the top-up amount which results from a reference to a withholding tax credit of one of the foreign 100% subsidiaries (e.g. the foreign corporate tax entity that made the key distribution) and a franking credit calculated under the general rule does not exceed 15% of the gross amount of the key distribution received by the Australian entity, it may continue to trace foreign withholding tax paid by other foreign 100% subsidiaries in the chain of entities. Tracing can continue until the total of all franking credits that the Australian entity can claim under the general rule and the top-up rule has reached an amount that is 15% of the gross amount of the key distribution received from the foreign entity. However, the total of franking credits may be less than 15% if there are insufficient top-up amounts.

How are withholding tax credits calculated?

8.45 There is a formula for calculating a ‘withholding tax credit’ which may be used to top up a franking credit calculated under the general rule ***[Schedule 2, item 1, subsection 160-170(2)]***. This is demonstrated in more detail in paragraphs 8.55 and 8.56.

8.46 The formula for calculating a withholding tax credit is:

$$\frac{\text{Amount of the flow-on distribution (equivalent to a frankable distribution)}}{\text{The sum of the amount of all prior equivalent foreign distributions received in the chain of entities test period by the entity making the flow-on distribution} - \text{The sum of the amounts of tax withheld on those prior equivalent foreign distributions} - \text{Expenses relating to those prior equivalent foreign distributions}} \times \text{Sum of adjusted withholding tax on prior equivalent foreign distributions}$$

8.47 In calculating an amount of withholding tax credit using the formula, it is necessary to refer to the amounts of distributions equivalent to frankable distributions received and flow-on distributions equivalent to frankable distributions made by each foreign 100% subsidiary. For this purpose, it is not necessary to match distributions made with those received. Distributions may be made out of a pool of existing undistributed profits as well as from the pool of distributions equivalent to frankable distributions received. Distributions made may in fact exceed those received. The absence of a requirement to match distributions received and made will increase the chances of withholding tax credits being created and used to top up franking credits equal to 15% of the key distribution.

8.48 The prescribed formula at paragraph 8.46 would produce an unintended result where the flow-on distribution (the numerator in the prescribed formula) is greater than the sum of the amount of all prior equivalent foreign distributions received in the chain of entities test period and the amount of tax withheld, assuming there are no expenses to be deducted from the prior equivalent foreign distributions (the denominator). Where this occurs, a withholding tax credit resulting from the application of the formula would be greater than the amount of withholding tax paid after deducting any entitlements under a compensation scheme and after applying the 15% limit (the *adjusted withholding tax on a prior equivalent foreign distribution*). To avoid this result, where the numerator exceeds the denominator, the withholding tax credit is limited to the sum of the adjusted withholding tax on prior equivalent foreign distributions. ***[Schedule 2, item 1, subsection 160-170(3)]***

8.49 A further unintended result would arise if expenses incurred in deriving distributions equivalent to frankable distributions were not taken into account in determining the denominator in the prescribed formula. For example, a foreign entity whose income is comprised solely of distributions received would not become entitled to a full withholding tax credit under the prescribed formula (see paragraph 8.46) if the entity incurred expenses in deriving those distributions. This is because the amount available for making flow-on distributions (which affects the numerator) would be less than the amount of prior equivalent foreign distributions received (the main factor in the denominator). As a consequence, such a foreign member of a chain of entities proposing to distribute all of its income from year to year would not receive full value under the prescribed formula for any withholding tax paid on distributions received. Deducting from the amount of prior equivalent foreign distributions received, expenses incurred in deriving those distributions would, accordingly, maximise the withholding tax credit that could arise from the application of the prescribed formula.

8.50 If the sum of the amount of expenses and the amount of tax withheld is equal to or greater than the amount of prior equivalent foreign distributions received, the denominator in the formula would be zero or negative. This would lead to an indeterminate or nonsensical outcome. The problem is overcome by allowing a withholding tax credit equal to the sum of the adjusted withholding tax on prior equivalent foreign distributions. ***[Schedule 2, item 1, subsection 160-170(4)]***

What withholding tax will give rise to withholding tax credits?

8.51 Generally, any withholding tax paid on a foreign distribution equivalent to a frankable distribution received by a member of a chain of entities will give rise to a withholding tax credit under the top-up rule. However, the same principles applying under the general rule to withholding tax also apply for the top-up rule. That is, the withholding tax paid:

- cannot exceed 15% of the gross distribution equivalent to a frankable distribution;
- can only be taken into account on the day it is paid;
- must be an amount which the receiving entity is personally liable to pay; and
- excludes any entitlements under a compensation scheme to which the entity, a member or an associate of either is entitled (see paragraph 8.22).

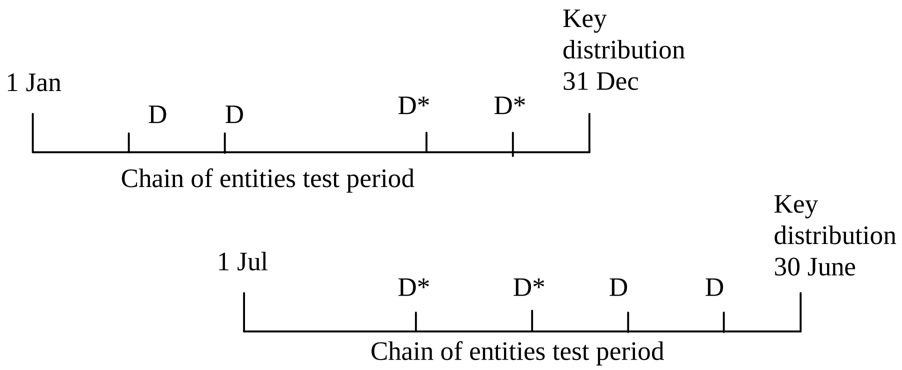
8.52 Paragraphs 160-170(1)(a) and 160-170(1)(c) apply to a distribution equivalent to a frankable distribution. Where a distribution is comprised of a mixture of frankable and unfrankable portions, only the withholding tax attributable to the part of the distribution equivalent to a frankable distribution can be used in the calculation of a withholding tax credit (see also paragraphs 8.20 and 8.21).

Double counting of withholding tax credits is excluded

8.53 Double counting of withholding tax credits would occur where more than one distribution equivalent to a frankable distribution passes through a chain of entities within a 12 month period and some of those distributions, on which withholding tax was paid, are common to more than one chain of entities test period – see Diagram 8.2. To avoid double counting, withholding tax credits that were available to be taken into account (regardless of whether they are actually taken into account) in calculating a previous top-up amount are to be disregarded in a later calculation ***[Schedule 2, item 1, paragraph 160-165(1)(g)]***. Accordingly, any withholding tax credits that could not, partly or wholly, be used under the top-up rule for a particular key distribution will be lost. However, distributions on which withholding tax was paid, made before a key distribution, and which are not passed on, may become part of a subsequent flow-on and key distribution in a later chain of entities test period. Where this occurs, the withholding tax credit of each eligible entity will be available for topping up a franking credit calculated under the general rule.

8.54 Diagram 8.2 illustrates possible double counting that could arise but for paragraph 160-165(1)(g).

Diagram 8.2: Avoiding double counting of withholding tax credits



D = distributions by members of chain of entities

* = distributions by the same member where the withholding tax paid is common to 2 chain of entities test periods.

How is the top-up amount calculated?

8.55 To make a calculation of a top-up amount, it is necessary to have the following amounts:

- the amount of a distribution received from a foreign entity;
- the amount of withholding tax paid on the distribution received;
- if appropriate, the withholding tax paid that is attributable to a foreign distribution equivalent to a frankable distribution;
- expenses (not including entity taxes paid on a distribution) incurred in deriving the distribution equivalent to a frankable distribution – ***expenses relating to a prior equivalent foreign distribution*** (see paragraphs 8.49 to 8.50) ***[Schedule 2, item 1, subsection 160-170(2)***;
- any amount which the distributing entity, the receiving entity or any associate of either is entitled to receive under a compensation scheme;
- the amount of withholding tax on a distribution equivalent to a frankable distribution received after deducting an entitlement under a compensation scheme and ignoring any excess over 15% of the gross distribution – the ***adjusted withholding tax on a prior equivalent foreign distribution*** ***[Schedule 2, item 1, subsection 160-170(5)***; and
- the amount of the distribution equivalent to a frankable distribution made to a member of the chain of entities (*flow-on distribution*) in the chain of entities test period after having received a foreign distribution equivalent to a frankable distribution.

8.56 Example 8.2 demonstrates the calculation of a top-up amount for an Australian corporate tax entity (Aust Co) from withholding tax credits of entities in a chain of entities.

Example 8.2: Calculation of a top-up amount

In this example:

FD	=	foreign distribution equivalent to a frankable distribution
FHC	=	foreign holding company
FS	=	foreign subsidiary
FWT	=	foreign withholding tax paid on a distribution by the entity receiving that distribution.
disbn	=	distribution

Assume:

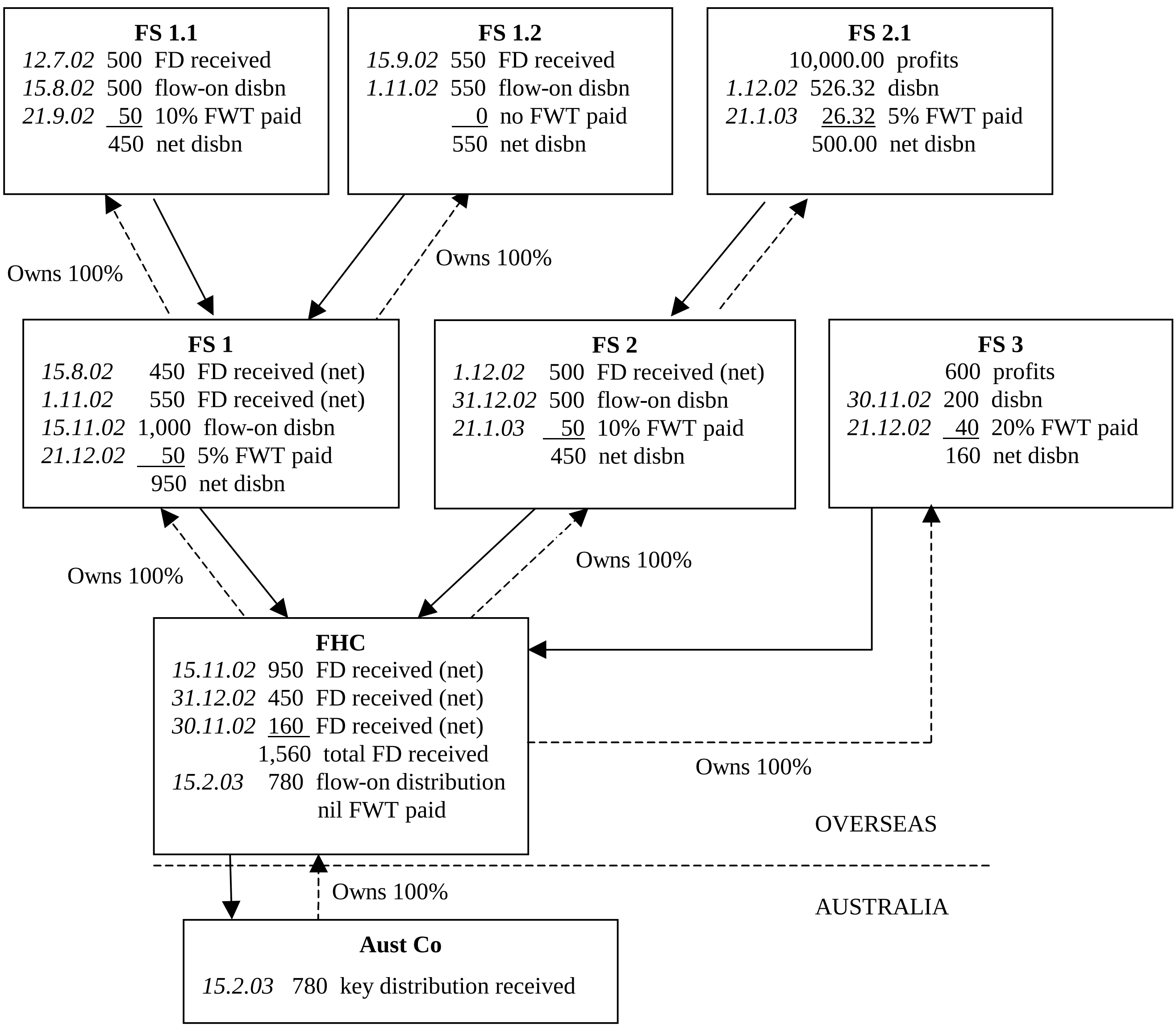
There are no entitlements under a compensation scheme.

No expenses were incurred by any entity in deriving the foreign distributions they received.

All entities other than Aust Co are foreign corporate tax entities.

The whole of each distribution is equivalent to a frankable distribution.

The distributions are the only distributions received and made in the chain of entities test period that have not been used previously in the calculation of a franking credit under the top-up rule.



In order to calculate the top-up amount, Aust Co undertakes the following steps.

Step 1: Calculate the maximum amount of the top-up amount.

15% of the gross distribution received = $117 (15% of 780)

less franking credit amount under general rule = nil

Maximum top-up amount possible for Aust Co = $117

Step 2: Determine the chain of entities test period.

As no withholding tax was paid by Aust Co, the chain of entities test period is a 12 month period that ends on the day on which the key distribution was made to Aust Co. The chain of entities test period is 16.2.2002 to 15.2.2003.

Withholding tax paid by foreign 100% subsidiaries on distributions made to a member in the chain of entities in this period may be used to determine the top-up amount.

Step 3: Determine all the members in the chain of entities which have received a foreign distribution equivalent to a frankable distribution and have made a flow-on distribution in the chain of entities test period. All the distributions must occur before the key distribution was made.

These are FHC, FS 1, FS 2, FS 1.1 and FS 1.2.

The distribution from FS 2.1 to FS 2 is a distribution equivalent to a frankable distribution because the distribution is made from a foreign entity to a member in the chain of entities and it is a distribution equivalent to a frankable distribution.

Step 4: Calculate the withholding tax credit for each entity using the formula in paragraph 8.46:

FHC

Gross amount of flow-on distribution made by FHC = $780

Sum of prior equivalent foreign distributions received by FHC:

= $1,700 ($1,000 + $500 + $200)

Sum of withholding tax deducted from distributions received:

= $140 ($50 + $50 + $40)

Adjusted withholding tax paid on the amounts that FHC received:

= $130 ($50 + $50 + $30*)

* FHC paid 20% foreign withholding tax on the distribution from FS 3. The adjusted withholding tax amount on that distribution will be:

$30 (15% of $200).

The remaining $10 of withholding tax cannot be used in calculating a franking credit at a future time.

FHC withholding tax credit

$$= \frac{\$780}{\$1{,}700 - \$140 - \$0} \times \$130$$

$$= \$65$$

The remaining $65 (i.e. $130 – $65) of withholding tax cannot be used in calculating a franking credit at a future time.

FS 1

Gross amount of flow-on distribution made by FS 1:

$$= \$1{,}000 \ (\$950 + \$50)$$

Sum of prior equivalent foreign distributions received by FS 1:

$$= \$1{,}050 \ (\$500 + \$550)$$

Sum of withholding tax deducted from distributions received:

$$= \$50 \ (\$50 + \$0)$$

Adjusted withholding tax paid on the amounts that FS 1 received:

$$= \$50$$

FS 1 only paid withholding tax on the distribution from FS 1.1 in the amount of $50. As this is less than 15% of the gross distribution this is the adjusted withholding tax amount.

FS 1 withholding tax credit:

$$= \frac{\$1{,}000}{\$1{,}050 - \$50 - \$0} \times \$50$$

$$= \$50$$

FS 2

Gross amount of flow-on distribution made by FS 2:

= \$500 (\$450 + \$50)

Sum of prior equivalent foreign distributions received by FS 2:

= \$526.32

Sum of withholding tax deducted from distributions received:

= \$26.32

Adjusted withholding tax paid on the amounts that FS 2 received:

= \$26.32

FS 2 paid a withholding tax on the distribution from FS 2.1 in the amount of \$26.32. As this is less than 15% of the gross distribution this is the adjusted withholding tax amount.

FS 2 withholding tax credit:

$$= \frac{\$500}{\$526.32 - \$26.32 - \$0} \times \$26.32$$

= \$26.32

Step 5: Calculate the total of all withholding tax credits calculated under step 4 for all the 100% subsidiaries in the chain of entities. This amount is compared to the amount calculated in step 1.

The total withholding tax credits calculated under step 4 is:

\$141.32 (\$65 + \$50 + \$26.32).

As this amount is greater than \$117, Aust Co can claim a franking account credit for \$117. The balance of \$24.32 is not able to be used in calculating a franking credit at a future time.

To further clarify this example, withholding tax credits for FS 1.1 and FS 1.2 would only be calculated if it is apparent that those credits would be needed to top up the franking credits of the Australian entity.

No withholding tax credit was calculated for FS 3 as it did not receive any foreign distribution equivalent to a frankable distribution.

Application and transitional provisions

8.57 The application and transitional provisions in relation to this measure will be addressed in a later Bill.

Consequential amendments

8.58 The consequential amendments in relation to this measure will be addressed in a later Bill.

Chapter 9
Transitional restructure relief: fixed trusts and companies

Outline of Chapter

9.1 This exposure draft introduces into the ITAA 1997 transitional CGT and other relief for certain transfer of assets from one entity to another where the underlying economic interests in the assets remain unchanged.

Context of reform

9.2 The purpose of the provisions is to offer some taxpayers the flexibility to restructure prior to the commencement of the non-fixed trust regime without triggering CGT or certain other tax consequences.

Summary of new law

9.3 Two types of CGT restructure relief are provided for in Subdivision 125 of the ITAA 1997:

- a fixed trust transfers all of its assets or business to a company and ceases to exist; and
- a widely-held company transfers all of its assets or business to a widely-held fixed trust and ceases to exist. ***[Schedule 3, item 1, Subdivision 125-A]***

9.4 The relief limits the tax consequences for the transferor, and the member, on the transfer of an asset to another entity.

Comparison of key features of new law and current law

New law	***Current law***
Two types of CGT roll-over and other relief are provided on the restructuring of entities that occurs in the period prior to the introduction of non-fixed trust rules.	Entity restructures that do not fit within the existing CGT roll-over measures produce CGT and other tax consequences for the parties associated with the restructure.

Detailed explanation of the new law

9.5 The object of Division 125 is to provide CGT roll-over and certain other relief on the restructuring of entities that occurs in response to the introduction of the non-fixed trust regime. ***[Schedule 3, item 1, section 125-5]***

Subdivision 125-A: Trust to company and company to trust relief

9.6 Subdivision 125-A provides relief for *entity restructuring* under which:

- a fixed trust transfers all of its assets to a company; or
- a widely-held company transfers all of its assets to a widely-held fixed trust. ***[Schedule 3, item 1, section 125-10]***

9.7 The transferor and transferee must both choose to obtain the relief. This means that a member automatically receives the benefits of that choice. ***[Schedule 3, item 1, section 125-20]***

What is the relief?

9.8 The relief provided under entity restructuring is:

- any capital gain or capital loss made by the transferor for any assets transferred under an entity restructure is disregarded;
- the cost base of the transferor for each asset transferred becomes the first element of the cost base or reduced cost base for that asset for the transferee; and
- the pre-CGT status of the transferred asset is maintained.

[Schedule 3, item 1, subsections 125-15(1) to (3)]

9.9 The relief extends to all CGT assets, including trading stock, plant and revenue assets. The transferor does not include any amount in its assessable income nor can it claim any deduction as a result of the disposal of such CGT assets under an entity restructuring. ***[Schedule 3, item 1, subsection 125-15(4)]***

9.10 Any asset treated by a transferee as trading stock, plant or a revenue asset is taken to have been acquired by the transferee for an amount equal to its cost base for the transferor just before the entity restructuring.

9.11 The characterisation of assets such as trading stock, plant or revenue assets does not pass with the asset from the transferor to the transferee. The transferee may choose to treat the asset as trading stock, plant or a revenue asset following the transfer, and the relevant provisions of the ITAA 1997 will apply at that time. ***[Schedule 3, item 1, subsection 125-15(5)]***

9.12 Trading stock, plant and revenue assets cannot produce a discount capital gain, nor can any gain or profit on their disposal qualify for the small business relief measures in Division 152 of the ITAA 1997. This will not change if the transferee does not treat the asset as trading stock, plant or a revenue asset. ***[Schedule 3, item 1, subsection 125-15(6)]***

Effect for members

9.13 CGT roll-over relief applies if a member's original interest in the transferor ends and a replacement interest in the transferee is received because of the entity restructuring. ***[Schedule 3, item 1, subsection 125-25(1)]***

9.14 The consequences for the member are:

- any capital gain or capital loss from the original interest in the transferor ending under the entity restructuring (because of CGT event C2) is disregarded;
- the first element of the cost base and reduced cost base of a replacement interest is worked out by allocating to each replacement interest a reasonable proportion of the total cost bases and reduced cost bases of the original interests in the transferor; and
- if the original interest in the transferor was acquired by the member pre-CGT, the replacement interest retains this pre-CGT status.

[Schedule 3, item 1, subsections 125-25(2) to (4)]

Example 9.1

George owns 2,000 shares of one class in the transferor comprising 1,000 pre-CGT shares each with a cost base of $10 and 1,000 post-CGT shares each with a cost base of $20. He receives 2,000 units of one class as his replacement interests.

George's replacement interests comprise 1,000 pre-CGT units and 1,000 post-CGT units. In working out the cost base of his replacement post-CGT units, George would receive a cost base of $20 each.

Example 9.2

Assume the same facts in Example 9.1 except that all of George's shares in the transferor are post-CGT.

The 2 parcels of shares should be added together with the result that the cost base of each of George's replacement units is $15.

Example 9.3

> Sonja owns 2,000 units of one class in the transferor of which 1,000 units were acquired pre-CGT and 1,000 units were acquired post-CGT.
>
> Sonja receives 750 shares of one class in the transferee as replacement interests. Sonja is taken to have acquired 375 (50%) of the replacement shares pre-CGT and 375 (50%) post-CGT.

Membership interest that is trading stock or a revenue asset

9.15 The relief extends to all original shares, units or other fixed interests in the transferor, including interests that are held by the member as trading stock or as revenue assets. The member does not include any amount in assessable income nor can the member claim any deduction as a result of the original interest ending. ***[Schedule 3, item 1, subsection 125-25(5)]***

9.16 The characterisation of CGT assets such as trading stock or revenue assets does not pass to the replacement asset. The transferee may later choose to treat the asset as trading stock or a revenue asset following the transfer, and the relevant provisions of the ITAA 1997 will apply at that time. ***[Schedule 3, item 1, subsection 125-25(6)]***

9.17 Any replacement interest held by a member as trading stock or a revenue asset is taken to have been acquired by the member for an amount equal to its cost base just before the entity restructuring. ***[Schedule 3, item 1, subsection 125-25(6)]***

9.18 Trading stock and revenue assets cannot produce a discount capital gain, nor can any gain or profit on their disposal qualify for the small business relief measures in Division 152 of the ITAA 1997. The replacement interest, to the extent it relates to original interest trading stock and revenue interests will similarly not qualify for the discount or relief. ***[Schedule 3, item 1, subsection 125-25(7)]***

- 9.19 The cost of any membership interest remaining in the transferor is zero just after the entity restructuring. ***[Schedule 3, item 1, subsection 125-25(8)]***

Conditions for relief

9.20 The conditions for entity restructuring relief are:

- the restructuring must occur on or after 1 pm, by legal time in the Australian Capital Territory, on 11 November 1999, and before 1 July 2001;
- the disposal of all of the assets of the transferor must occur at the same time. Disposals over a period of time do not qualify for the relief. Assets acquired by the transferor after this date of transfer do not qualify for the relief;

- the transferor must cease to exist within 6 months of the transfer time. If circumstances beyond the control of the transferor prevent the winding up, dissolution or vesting, the transferor can apply for an extension of the period;

- the transferee must be a company or trust that is not an exempt entity and has no commercial history or any assets other than minimal cash (e.g. a shelf company acquired for the entity restructuring);

- replacement interests acquired in the transferee must be held in the same proportion as the original interests that were held in the transferor. The market value of the replacement interests must also be at least substantially the same as the original interests. This test ensures that beneficial ownership of the entity is maintained, and that there is no value shift between members under the entity restructuring; and

- the transferee must be a resident entity. If the original interests in the transferor are owned by a non-resident and have a necessary connection with Australia, the replacement interests must also have a necessary connection with Australia.

[Schedule 3, item 1, sections 125-30(1) to (6)]

Example 9.4

Tony, Linda and Norman own 10, 40 and 50 units of one class respectively in the transferor. The transferee issues 50 shares to them as replacement interests under an entity restructuring. Tony, Linda and Norman must receive 5, 20 and 25 shares of one class respectively.

Reversal of the relief under CGT event J4

9.21 CGT event J4 happens if roll-over relief under Subdivision 125-A is claimed and the transferor does not cease to exist within 6 months of the disposal or such extra time as allowed by the Commissioner. The time of the event is when the failure to satisfy the condition occurs. ***[Schedule 4, item 3, subsections 104-195(1) and (2)]***

9.22 A capital gain or capital loss may arise at the time of the J4 event for the CGT assets held by the transferee at that time. A capital gain or capital loss may also arise at the time of the J4 event for any membership interest held in the transferee at the time of the J4 event. ***[Schedule 4, item 3, subsections 104-195(3) and (5)]***

9.23 The transferee and member are treated as having disposed of their CGT assets (the transferred assets or the replacement interests respectively) for the market value of those assets at the time of the J4 event. The transferee and member are also treated as having acquired those assets just after the time of J4 event for their market value at that time. ***[Schedule 4, item 3, subsections 104-195(4) and (6)]***

Widely-held requirement

9.24 A company may claim roll-over relief under these provisions if it has 300 members and does not have concentrated ownership or possible variations of rights attaching to the shares that could cause concentrated ownership. The existing rules relating to the concentrated ownership and variation of rights tests are contained in section 124-780. ***[Schedule 3, item 1, subsection 125-10(2)]***

Application and transitional provisions

9.25 Division 125 of the ITAA 1997 applies to assessments for the income year in which 11 November 1999 occurs and later income years. ***[Schedule 3, item 2]***

Consequential amendments

9.26 Various minor consequential amendments are made to CGT provisions in Parts 3-1 and 3-3 of the ITAA 1997 to support the inclusion of Division 125 and CGT event J4. ***[Schedule 4, items 1, 2 and 4 to 15]***

9.27 The amendments in items 2, 3, 7 and 14 apply to assessments for the 2001-2002 income year and later income years. The amendments in the remaining items apply to assessments for the income year in which 11 November 1999 occurs and later income years. ***[Schedule 4, item 16]***

Chapter 10
Primary production averaging

Outline of Chapter

10.1 This Chapter explains when income averaging will be available to members of non-fixed trusts which carry on a business of primary production.

Context of reform

10.2 The non-fixed trust regime taxes non-fixed trusts similarly to the manner in which companies are taxed. Tax will be paid at the trust level and distributions will be made to members out of either available profits, contributed capital or prior taxed amounts. Under this treatment the character of the income as income from primary production would not, without special rules, flow-through to the beneficiary.

10.3 Primary production income averaging does not apply to companies, as companies are taxed at the uniform company rate and so do not experience any difference in overall tax as income varies. Furthermore, companies engaged in primary production business are able to retain income without penalty and thus shelter their shareholders from income fluctuations. Under the non-fixed trust regime, without special provisions, beneficiaries of trusts engaged in primary production would not be entitled to income averaging, in the same way that shareholders in companies engaged in primary production are not entitled to income averaging. That is, the character of the income as primary production income would not flow through to the members.

10.4 Many beneficiaries and beneficial objects of non-fixed trusts currently have access to averaging. Despite the change to the taxation of non-fixed trusts, family farming arrangements will continue to include trusts, and the Government has decided to maintain the access of beneficiaries and beneficial objects of such arrangements to primary producers' averaging. These measures ensure that certain members of non-fixed trusts will still be able to access primary producers' averaging.

Summary of new law

10.5 These rules will continue to enable members of non-fixed trusts to apply the primary production averaging provisions.

Comparison of key features of new law and current law

New law	*Current law*
Members of non-fixed trusts which carry on a business of primary production will be taken to carry on the business of primary production themselves if they receive a distribution from the trust in the year in which the business is carried on. They are entitled to apply averaging to their income. Beneficiaries of other trusts (other than corporate unit trusts and public trading trusts) will be entitled to apply averaging to their income on the same basis as under the current law.	Beneficiaries and beneficial objects of trusts which carry on a business of primary production and which are not corporate unit trusts or public trading trusts are taken to carry on the business of primary production themselves if they are presently entitled to a share of the trust income of the year in which the business is carried on. They are entitled to apply averaging to their income.

Detailed explanation of new law

10.6 Averaging applies to individuals who carry on a business of primary production. Certain beneficiaries and beneficial objects of trusts which carry on a business of primary production are taken to carry on a business of primary production and so may also be entitled to have their income tax liability averaged.

10.7 After 1 July 2001 income derived by non-fixed trusts will be taxed at the trust level and the character of the income will generally not flow through to the beneficiary. In relation to other trusts, the existing averaging provisions will apply to the beneficiaries without change. Thus, a presently entitled beneficiary of a fixed trust (other than a corporate unit trust or public trading trust) which carries on a primary production business will be treated as themselves carrying on the business and so entitled to averaging providing all the other conditions in Division 392 are satisfied. ***[Schedule 5, item 2, subsection 392-20(1)]***

10.8 In relation to non-fixed trusts, a member is taken to carry on the business of primary production carried on by the trust, and will hence be entitled to apply the averaging provisions if the trust makes a distribution to the member in the income year in which the trust carried on the primary production business. (The term ‘member’ includes both beneficiaries and beneficial objects of the non-fixed trust: see Chapter 2). ***[Schedule 5, item 1, subsection 392-19(1)]***

10.9 This means that members are not taken to carry on a primary production business other than when the trust does so. If the trust ceases to carry on a primary production business, so does the member. So members are not treated as carrying on the primary production business for longer than the trust, which actually carries on the primary production business, and cannot be taken to carry on a primary production business in years where the trust does not do so.

10.10 This also means that members do not carry on the primary production business in any year in which they do not receive a distribution from the trust, paralleling the current law under which beneficiaries do not carry on the primary production business in years in which they are not presently entitled to a share of the net income of the trust. Any members who do not share in distributions from the trust in a year are not closely enough involved to be treated as carrying on the trust's primary production business of that year. So averaging will not be available to those members.

10.11 The difference between this treatment and the current law is small, but necessarily reflects the difference between the concept of present entitlement to a share of net income under the current law, and the concept of receiving a distribution under the non-fixed trust regime. Access by members to averaging will continue to be controlled by the trust itself.

10.12 A member is not taken to carry on a business of primary production if the distribution is less than $1,040, unless the Commissioner is satisfied that the interest in the non-fixed trust was not acquired or granted wholly or primarily to enable the member to apply the averaging provisions. This restriction is the same as the restrictions for beneficiaries of other trusts (for which the rule is expressed in terms of a present entitlement to a share of trust income of the year of less than $1,040). ***[Schedule 5, item 1, subsection 392-19(2)]***

10.13 Before the commencement of the non-fixed trust regime, beneficiaries of trusts which were corporate unit trusts or public trading trusts were never taken to carry on those trusts' primary production businesses and so were not entitled to apply averaging to their income. This restriction continues as the Government undertook only to maintain access for currently eligible beneficiaries and not extend access. ***[Schedule 5, item 1, subsection 392-19(3)]***

10.14 The member will calculate the averaging adjustment in accordance with Subdivision 392-B. One of the main concepts in this Subdivision is the concept of ***basic taxable income***. This is defined in subsection 392-15(1) as assessable income less certain types of income. Assessable income will include the sum of the distribution and the imputation credit. This is achieved under the existing rules for amounts of income taxed to the trustee, and will be achieved under the non-fixed trust regime, by the existing definition of 'assessable primary production income' in subsection 392-80 of the ITAA 1997 and its use in the averaging rules. So no amendment in this respect is proposed.

Application and transitional provisions

10.15 These amendments apply to assessments for the 2001-2002 year and all later years. ***[Schedule 5, item 3]***

Consequential amendments

10.16 There are no consequential amendments.

Chapter 11
Farm management deposits

Outline of Chapter

11.1 This Chapter explains when a member of a non-fixed trust which carries on a business of primary production will be eligible to make a farm management deposit.

Context of reform

11.2 The non-fixed trust regime taxes non-fixed trusts similarly to the manner in which companies are taxed. Tax will be paid on income earned by the trust at the trust level and distributions will be made to members out of either profits, contributed capital or prior taxed amounts. Under this treatment, the character of the income as income from primary production would not, without special rules, flow-through to the beneficiary.

11.3 Companies and their shareholders cannot make farm management deposits as companies are taxed at the uniform company rate and so do not experience any difference in overall tax as income varies. Furthermore, companies engaged in a primary production business are able to retain income without penalty and thus shelter their shareholders from income fluctuations. Under the non-fixed trust regime, without special provisions, beneficiaries of trusts engaged in primary production would not be entitled to make farm management deposits, in the same way that shareholders in companies engaged in primary production are not entitled to make farm management deposits. That is, the character of the income as primary production income would not flow through to them.

11.4 Many beneficiaries and beneficial objects of non-fixed trusts currently make such deposits. Despite the change to the taxation of non-fixed trusts, family farming arrangements will continue to include trusts, and the Government has decided to maintain the access for beneficiaries and beneficial objects of such arrangements to farm management deposits. These measures ensure that certain members of non-fixed trusts will still be able to access farm management deposits.

Summary of new law

11.5 These rules will enable members of non-fixed trusts to continue to be eligible to make farm management deposits.

Comparison of key features of new law and current law

New law	*Current law*
Members of non-fixed trusts which carry on a business of primary production will be primary producers themselves when the trust carries on that business if they receive a distribution by the trust in the year. As primary producers they are eligible to make a farm management deposit. Beneficiaries of other trusts which carry on a business of primary production will be eligible to make a farm management deposit on the same basis as under the current law.	Beneficiaries and beneficial objects of trusts which carry on a business of primary production are primary producers themselves when the trust carries on that business if presently entitled to a share of net income of the trust of the year. As primary producers they are eligible to make farm management deposits.

Detailed explanation of new law

11.6 Division 393 of Schedule 2G to the ITAA 1936 allows primary producers, including certain beneficiaries and beneficial objects of trusts which carry on a business of primary production, to make farm management deposits. The primary producer may then be entitled to deduct the amount of the deposit from their assessable income. The amount of the deduction will be assessed when the farm management deposit is withdrawn.

11.7 After 1 July 2001 income derived by non-fixed trusts will be taxed at the trust level and the character of the income will generally not flow through to the beneficiary. These rules ensure that members and beneficiaries of both fixed and non-fixed trusts will still be entitled to take advantage of the farm management deposit provisions on the same basis as under the current law.

11.8 To be entitled to make a farm management deposit, the taxpayer must be a primary producer when the deposit is made (subsection 393-35(2)). A beneficiary of a trust which is fixed is a primary producer if the beneficiary is not a company and is presently entitled to a share of the income of a trust which carries on in Australia a primary production business. The amendments mirror this treatment for members of non-fixed trusts. (The term ‘member’ includes both beneficiaries and beneficial objects of non-fixed trusts: see Chapter 2.) Thus, a member of a non-fixed trust which carries on a business of primary production, will be taken to carry on a business of primary production providing the member is not a company and they receive a distribution from the trust in the income year in which the trust carries on the business of primary production. ***[Schedule 6, item 6, definition of 'primary producer' in paragraph 393-25(ba)]***

11.9 This means that members are not taken to carry on a primary production business other than when the trust does so. If the trust ceases to carry on a primary production business, so does the member. So members are not treated as carrying on the primary production business for longer than the trust, which actually carries on the primary production business, and cannot be taken to carry on a primary production business in years where the trust does not do so.

11.10 This also means that members do not carry on the primary production business in any year in which they do not receive a distribution from the trust, paralleling the current law under which beneficiaries do not carry on the primary production business in years in which they are not presently entitled to a share of the net income of the trust. Any members who do not share in distributions from the trust in a year, are not closely enough involved to be treated as carrying on the trust's primary production business of that year. So farm management deposits will not be available to those members.

11.11 The difference between this treatment and the current law is small, but necessarily reflects the difference between the concept of present entitlement to a share of net income under the current law, and the concept of receiving a distribution under the non-fixed trust regime. Access by members to deposits will continue to be controlled by the trust itself.

11.12 When the member carries on a primary production business is important, because farm management deposits must be repaid once the owner of the deposit (the member) ceases to be a primary producer for a continuous period of at least 120 days, as well as on the death or bankruptcy of the owner.

11.13 The member may deduct the amount of a deposit from their assessable income providing all the other conditions of Division 393 are satisfied. Subsection 393-10(2) limits the deduction to the amount of 'taxable primary production income' derived in that year. The calculation of 'taxable primary production income' involves ascertaining the 'assessable primary production income' under subsection 393-60(2) of the ITAA 1997. For a member of a non-fixed trust, this amount will include the net distribution plus any relevant imputation credits. For beneficiaries of trusts under the current law, it includes gross amounts subject to tax to the trustee, and the existing wording does not require amendment to maintain this appropriate gross treatment in relation to members of non-fixed trusts.

11.14 Generally, the primary producer must be the one that makes the deposit. If the beneficiary who is the primary producer is under a legal disability, the trustee may make the deposit on their behalf. A trustee of a non-fixed trust may make a deposit on behalf of a member who is under a legal disability in the same way as the trustee of a fixed trust. ***[Schedule 6, item 8, paragraph 393-35(4)(aa)]***

11.15 In relation to all trusts, including those which are fixed, the term 'trust estate' has been replaced with the term 'trust'. This is a convenient change in terminology only and does not represent a substantive change in the provisions as they relate to fixed trusts. ***[Schedule 6, items 2, 3, 5, 7, 9 and 10, omission of 'estate' following 'trust' in section 393-25, definition of 'depositor', definition of 'owner' and definition of 'primary producer' in subsection 393-35(4)]***

11.16 Before commencement of the non-fixed trust regime, companies including corporate limited partnerships and trusts taxed as companies were not entitled to make farm management deposits. They were excluded from the definition of 'primary producer' in their own right, as partners in partnerships carrying on primary production business and beneficiaries of trusts carrying on primary production business. After commencement companies will still not be entitled to make a farm management deposit and are specifically excluded from the definition of 'primary producer', whether in their own right, as partners or as beneficiaries.

11.17 Existing references to 'beneficiary' are extended to include 'member', reflecting the operation of the non-fixed trust regime. ***[Schedule 6, items 1 and 4, section 393-25, definitions of 'depositor' and 'owner']***

Application and transitional provisions

11.18 The amendments apply to assessments for the 2001-2002 income years and all later years. ***[Schedule 6, item 11]***

Consequential amendments

11.19 There are no consequential amendments.

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