

Blake Dawson

The General Manager
Business Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

T 61 2 9258 6000
F 61 2 9258 6999
DX 355 Sydney

Locked Bag No 6
Grosvenor Place
Sydney NSW 2000
Australia

www.blakedawson.com

Dear Sir

18 March 2011

Submission on 'Improving the taxation of trust income' discussion paper

We welcome the opportunity to comment on the March 2011 Discussion paper titled 'Improving the taxation of trust income' (**Paper**).

Summary

For the reasons noted below, we believe:

- The general approaches outlined in Chapter 2 of the Paper in defining the concept of 'distributable income' is not feasible if the concept of 'present entitlement' is retained.
 - Some alternative method of determining who is assessable on the net income (taxable income) is needed.
 - An outline of a proposal is attached as an appendix, which is broadly a cash basis approach supplemented by a 'last resort' trustee tax regime with a tax rate of 30%.
- We welcome and support the ideas outlined in Chapter 3 of the Paper to clarify the ability of trusts to stream franked dividends and capital gains.

Partner

Paul O'Donnell
T 61 2 9258 5734
paul.o'donnell@blakedawson.com

Contact

Chris Kim
T 61 2 9258 6723
chris.kim@blakedawson.com

Submission

1. With respect, the proposed approach in Chapter 2 is not feasible

We support the policy of aligning the commercial substance and the tax outcome for trusts. Nevertheless, we do not support the approaches outlined in Chapter 2 of the Paper.

With respect, the general approaches outlined in Chapter 2 to define the concept of 'income of the trust estate' would not operate as intended if the concept of present entitlement is retained in the legislation.

1.1 Consequences

We foresee two consequences if the Treasury's approach in Chapter 2 is enacted:

- (a) The courts may hold that the income of the trust will be taxed at the trustee level only, because the beneficiaries can only be presently entitled to the trust law income of the trust only (determined by general law and the trust deed). Since no beneficiary can be presently entitled to the tax law trust income (current proposal), the trustee will pay tax on their behalf.
- (b) If the proposed change of including the definition of 'income of a trust estate' (**tax law income**) were interpreted as altering the trust relationships between trustees and beneficiaries as a matter of general law, the width of the legislative power of the Commonwealth may be tested.

Contrary to the point made in (b) above, we assume that the Treasury is not intending to unilaterally amend the terms of all trusts, present and future. However, if what is intended is that beneficiaries will be deemed to be presently entitled (in tax law, but not trust law) to tax law income, then there will continue to be a disparity between the cash received by beneficiaries and the tax liability of the beneficiaries (discussed further at 1.4). It would seem to us that this would not achieve any improvement on the current system.

Reasons for the submission

1.2 Present entitlement in taxation

The gateway for taxation of trust is the concept of 'present entitlement'. For a beneficiary to be assessed on trust distribution, that beneficiary must be presently entitled (or deemed to be presently entitled) to the income of the trust estate.¹ In very broad terms, for a trustee to be assessed on the 'net income' or taxable income of the trust estate, there must be income of the trust estate, for which no beneficiary is presently entitled.²

The concept of 'present entitlement' has been construed by the courts as taking the meaning under the general laws.

With great respect, it appears to us that these provisions must be construed in the light of the general principles of law applicable to the administration of estates by executors and trustees at law and in equity. The crucial question is at what moment of time, having regard to these general principles and to the provisions of the trust instrument, can it be said that a beneficiary has become presently entitled to a share in the income of a trust estate.

- *FCT v Whiting* (1943) 68 CLR 199, affirmed in *Taylor v FCT* [1970] HCA 10

The meaning of the words "presently entitled" has been taken to accord with the general principles of entitlement applied in law and equity.

- *Federal Commissioner of Taxation v Harmer and Others* (1990) 94 ALR 541

Indeed, the Federal Court has suggested that the whole phrase 'presently entitled to a share of the income of the trust estate' is defined by the general law of trusts:

Further, the phrase "presently entitled to a share of the income" directs attention to the processes in trust administration by which the share is identified and entitlement established.

- *Colonial First State Investments Ltd v FCT* [2011] FCA 16 at paragraph 26

Thus the concept of present entitlement in trust context is clearly a trust law concept.

¹ See s 97 of *Income Tax Assessment Act 1936* (ITAA 1936)

² See s 99 of ITAA 1936

1.3 Present entitlement under general law

Under trust law, if the trustee purports to make a beneficiary presently entitled to something that the trustee is not entitled to distribute under the trust deed, the purported exercise may be in breach of trust.³

A corollary of the above statement is that a beneficiary can only ever be presently entitled to what the trustee can validly distribute (ie determined under equity and the trust deed).

We note that the phrase "income of the trust estate" is understood from trust law perspective:

The Full Court of this Court's decision in *Cajkusic v Commissioner of Taxation* [2006] FCAFC 164; (2006) 155 FCR 430 ("*Cajkusic*") seems to us to require that the expression "the income of the trust estate" be interpreted as meaning the income of the trust as understood in trust law.

- *Bamford v FCT* [2009] FCAFC 66 at para 73

We submit that simply legislating a definition of "income of the trust estate" to be something other than the income of the trust under the trust law, but still retaining the trust law concept of 'presently entitled', will render the whole phrase "presently entitled to a share of the income of the trust estate" not feasible to apply.

1.4 Deemed present entitlement

With respect, if the beneficiaries were deemed (for tax law purposes) to be presently entitled to tax law income without changing the trust law income entitlement, the discrepancy between the tax liability of a beneficiary and the cash they receive will continue.

For example, the trust law income is \$50 and a beneficiary receives \$50 from the trust.

Under the current proposal, if the tax law income of the trust is \$100, the beneficiary may be deemed to be presently entitled to the tax law income of \$100 for tax purposes.

If the net income of the trust is \$120, the beneficiary would be assessed on \$100/\$100 of \$120, which is \$120. Under the current law, the beneficiary would be assessed on \$50/\$50 of \$120, which is \$120 also.

With respect, it is not be clear to us what would be achieved by this proposal.

1.5 An alternative proposal – cash basis

With respect, we propose a cash basis of taxing trust distributions as an alternative means of achieving the policy objective of aligning the economic substance and the tax outcome.

In broad terms, the alternative proposal taxes the beneficiaries on their trust distribution (trust law concept).

To the extent that there is net income of the trust (tax law concept) not distributed to beneficiaries as at year end, the trustee would instead be taxed at 30%.

Any subsequent distribution of that income would carry franking credits in order to avoid double taxation.

We provide more detail in Appendix A.

³ *Attorney-General (UK) v Downing* (1767) Wilm 1; 97 ER 1, Wilmot LCJ at 23 (Wilm); *Davey v Thornton* (1851) 9 Hare 222; 68 ER 483; *Bamford v Commissioner of Taxation* [2009] FCAFC 66 at para 52

2. Chapter 3 – Streaming of franked distributions and net capital gain

We support the proposed methods outlined in Chapter 3 to amend the legislation to clarify that the trustee is able to stream of franked distributions and capital gains to different beneficiaries.

3. Specific Questions

We provide the answers to some of the questions listed in pages 19 and 20 of the Paper.

Questions 1, 2, 3 and 5 of the Paper are difficult to answer in light of our submission that the phrase "presently entitled to a share of the income of the trust estate" as a whole must be based on trust law, if the concept of 'presently entitled' is to be retained.

3.1 "4. Would the introduction of a specific anti-avoidance provision be effective to ensure that re-classification clauses could not be used to re-classify amounts of income or capital to obtain a tax benefit?"

We would appreciate greater clarification on the question.

We assume that the tax mischief referred to in Question 4 is not referring to the alleged ability of the trustees to define their way out of paying tax, an allegation that was rejected by the Federal Court.

The respondent submitted that '... what [is] income for trust law purposes, s 97 purposes, cannot be governed by what is said in the trust deed'. That, so the submission went, '... would be remarkable. You could just define your way out of what the Income Tax Assessment Act provides.' The submission is flawed for a number of reasons.

- *Cajkusic v Commissioner of Taxation* [2006] FCAFC 164 at para 21; applied in *Barnford* at para 57

We also assume that the tax benefit referred to in Question 4 is not referring to the ability of the trustee to stream franked dividends to those taxpayers who are able to utilise the franking credits or streaming capital gains to those taxpayers who are able to obtain concessional capital gains treatments. That assumption is based on Chapter 3 of the Paper titled "Enabling the streaming of franked distribution and net capital gains."

If our assumptions are correct, we do not understand that there is a tax benefit that needs to be addressed by a specific anti-avoidance provision.

If our assumptions are correct but our understanding is incorrect, we submit that the general anti-avoidance provisions in Part IVA of ITAA 1936 is sufficiently robust to address any tax mischief resulting from the proposed amendments.

3.2 "6. Apart from clarifying the operation of subsection 207-35(3) of the ITAA 1997 (in particular the meaning of the words 'despite Division 6') are other changes needed to ensure that Subdivision 207-B operates appropriately?"

We support the proposed legislative amendments in section 3.1.1 of the Paper in clarifying the operation of s 207-35(3).

With respect, we highlight the prescriptive formula contained in the table of s 207-55(3), which may operate to thwart any clarification made to s 207-35(3).

Additional amendments

We suggest the following additional amendment to ensure that Subdivision 207-B (**the Subdivision**) operates appropriately:

- (a) (replace) 207-55(3) The trustee must determine the reasonable notional allocation of an entity's share of a franked distribution.
- (b) (insert) 207-55(4) The trustee's determination will be evidenced by the way the entity treated the trust distribution in its tax return.

The effects of the above two amendments would be to remove the formulaic approach prescribed in the table in s 207-55(3) and confirm the notional approach envisaged in s207-55(2).

Section 207-55(2) states:

An entity's share of a franked distribution is an amount notionally allocated to the entity as its share of the distribution, whether or not the entity actually receives any of that distribution.

Reason - Uncertainty of the 'share' formula

The fundamental uncertainty surrounding the Subdivision arises as a result of the inherent difficulty of applying the 'share' formula in s207-55(3).

As an example, 'share' is defined in s 207-55 as being (column 3 of item 3 of the table in s 207-55(3)) "so much of the amount worked out under column 2 of this item ("if the trust has a positive amount of net income for that year – the amount of the franked distribution") as is taken into account in working out that share amount (worked out under s207-50(3)(b)(i) as being the "share of the trust's net income for that income year that is covered by paragraph 92(1)(a) of the *Income Tax Assessment Act 1936*".

Specifically, the difficulty arises because *Colonial First State Investments*⁴ confirmed that the 'share' is applied to the whole of the 'net income' of the trust:

As explained above, pursuant to s 97(1), it is a share (that is, a proportion) of the net income of the Wholesale Fund that would be included in the assessable income of the Retail Fund. When applied to the whole of the net income of the Wholesale Fund that proportion (which corresponds to the proportion of the Fund's distributable income to which the Retail Fund is presently entitled) yields an amount. That amount includes, not the Gain part, but only so much of the Gain part as corresponds with a net capital gain.

It is conceptually difficult (and susceptible to a number of different interpretations) to appropriately determine the share of the net income of the trust that corresponds to the franked distribution when the net income is a mixture of the different types of assessable incomes and is net of all deductions.

Accordingly, we propose that existing s 207-55(3) be repealed so that the notional allocation specified in s 207-55(2) will become the governing provision. We note that the suggested amendments are consistent with the proposed amendments to the Managed Investment Trusts regime.

⁴ 2011 FCA 16 at para 54

3.3 Questions 7 and 8 - Subdivision 115-C - capital gains

We support the inclusion of capital gains in beneficiary's assessable income.

Questions 7 and 8 of the Paper deal with interactions between the capital gains regime and taxation of trusts in Division 6 of the ITAA 1936.

We would like to reserve our views on Questions 7 and 8 until the other issues mentioned above have been resolved.

We would be happy assist further in the consultation process. Please do not hesitate to contact us if you have any questions regarding the above.

Yours faithfully

Blake Dawson

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Appendix A – Alternative proposal

With respect, we propose broadly a cash-basis system of taxing trust distributions.

1. The beneficiaries would be assessed on the lesser of:
 - a. trust distributions (trust law concept) received; and
 - b. net income of the trust.
2. The trustee would be taxed at 30% on the balance of the net income of the trust, if any.
3. The concept of present entitlement is no longer necessary.
4. The nature of the distribution from the tax perspective (eg franked distributions, capital gains) will be determined by the trustee for each beneficiary (see our suggestion to Question 6 of the Paper).

Examples

1. Trust law > tax law, 100% distribution	\$	2. Trust law > tax law, partial distribution	\$	3. Trust law > tax law, partial distribution	\$
Trust law income	100	Trust law income	100	Trust law income	100
Trust law distribution	100	Trust law distribution	50	Trust law distribution	50
Tax law income	80	Tax law income	80	Tax law income	20
Assessable income of the beneficiaries	80	Assessable income of the beneficiaries	50	Assessable income of the beneficiaries	20
Assessable income of the trustee at 30%	0	Assessable income of the trustee at 30%	30	Assessable income of the trustee at 30%	0
4. Trust law < tax law, partial distribution	\$	5. Trust law < tax law, partial distribution	\$		
Trust law income	100	Trust law income	100		
Trust law distribution	100	Trust law distribution	50		
Tax law income	200	Tax law income	200		
Assessable income of the beneficiaries	100	Assessable income of the beneficiaries	50		
Assessable income of the trustee at 30%	100	Assessable income of the trustee at 30%	150		