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The General Manager
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Dear Sir or Madam

SUBMISSION REGARDING MODERNISING THE TAXATION OF TRUST INCOME – OPTIONS FOR REFORM

This letter contains my submission regarding the modernisation of the taxation of trust income. I do not intend that this submission to be a fully referenced reply to the Options For Reform consultation paper, but to instead put forward some ideas that I believe could be an important part of a functional and much improved system of taxing trust income.

Taxation of Accumulated Income (Consultation Paper 6.4.3)

Introduction

The current tax on profits not distributed in a financial year from a trust could be reduced from 46.5% to 30%. This rate could be permanently reduced to the corporate tax rate.

The after-tax amount retained in the trust will then be available to reinvest back into the business, or to pay out to beneficiaries as an assessable capital distribution in a future year. The trust will receive credits for any tax paid, which will then be available when the retained amount is eventually distributed to beneficiaries.

Current anti-avoidance rules will need to be modified so that beneficiaries will not be able to gain access to the amount retained, without being taxed on the amount at their marginal rate, or entering into an agreement to repay the monies used.

Should wide application of this principle for all discretionary trusts not be desirable, then limiting this principle to certain smaller family discretionary trusts may be appropriate (using either the current family trust election provisions or the small business entity provisions).

Discussion

1. Reducing the current top marginal rate of tax on accumulated income.

   Don't dismiss this as an attempt to tax trusts like companies. By only taxing taxable trust income not distributed, but accumulated, the bulk of the deficiencies in attempts to tax trusts as companies are avoided. Trusts would in fact operate the way they always have, however the current top marginal tax rate that applies to undistributed income would instead be reduced and subject to a system of tax that is very similar to the taxation of a company's retained profits. I would be surprised if more than a minority of trusts in this country actually accumulate any income at all, so there would be no objection to this proposal from the majority of small business owners and primary producers that currently operate via a family trust structure.

Should a trustee not want to subject themselves to this sort of system, then they can do so by simply distributing all the income like they do now.

2. Allowing trusts to be an accumulation vehicle

By allowing trusts (especially family trusts) to accumulate income without being subject to a high rate of tax, you will remove a number of other problems.

The use of corporate beneficiary "bucket companies" is a widespread and longstanding practice of retaining trust taxable income at the corporate tax rate, with the after tax funds being available for use within the business. There is no mischief here: largely these are business owners who need to reinvest capital into the business. Division 7Aea (of the ITAA 1936) was put in place to prevent funds accumulated in these corporate beneficiaries from being used by individuals for private purposes without those funds first being taxed at the individuals marginal rates (or paid back in a reasonable time-frame).

However the recent Tax Office recent interpretation of the Division 7A rules regarding "financial accommodation" has now threatened this practice, and largely made the provisions in Division 7Aea redundant. This approach has threatened the use of trusts as an appropriate structure for operating a business. Accordingly there are other reasonably complicated structures now available that can allow the flexibility and advantages of a trust, but with the accumulation features of a company.

By allowing trusts to be an accumulation vehicle, you can avoid the bulk of these deficiencies and greatly simplify the taxation of trust income for a great proportion of family trusts. By having trusts that have accumulation features, you remove the necessity for complicated structures to exist just so a business can operate with working capital.

You would also partly sidestep the issue of the timing of a trust distribution. Many trustees may choose to always accumulate, and simply distribute a capital distribution of the taxable accumulations in a later year with associated tax credits (see below).

The existence of default beneficiary clauses may reduce the effectiveness of allowing trusts to accumulate income, however amending the deed to remove these clauses may not be strictly required. In most cases, all that would be required to accumulate the income would be a resolution of the trustee at any time during the income year that any amount not distributed is to be accumulated. It would be a poorly drafted default beneficiary clause that would override a resolution such as that.

3. For complying trusts to be an accumulation vehicle, you need a system similar to a franking account in a company.

For tax purposes only, you would have a taxable accumulations account which would contain any accumulations up to the equivalent of the taxable income that was taxed in the trust. You would maintain a franking account similar to a company that recorded tax paid. These imputation credits would be available on future distributions from the taxable accumulations account.

These future distributions would actually be capital distributions. However individuals would need to be taxed on these distributions similar to being taxed on dividends.

The Division 7A distributable surplus concept could be used to prevent a distribution of taxable accumulations in circumstances when subsequent losses would mean that these distributions could make the trust insolvent.

There may need to be some rules put in place for whether a non-taxable capital distribution can be made while there is a balance in the taxable accumulations account.

Any amount accumulated would lose the tax components of that income. Alternatively, if the class method of differentiating tax components is chosen, then potentially the taxable accumulations could retain these distinctions.

4. Anti-avoidance provisions would be required to prevent accumulated funds being used for private purposes.

Division 7A could apply to Trusts that have a taxable accumulation in a way that is similar to companies. Division 7A already applies to trusts with corporate beneficiaries in the form of Division 7Aea, therefore applying Division 7A itself to a trust that has a taxable accumulation should not pose many additional challenges. Loans to beneficiaries (or overdrawn entitlements) would be subject to division 7A up to the amount of the taxable accumulation, or division 7Aea up to the amount of any unpaid entitlement to a company (as they are now).

A complication that could exist is what would happen with a loan between the trust and a company. Currently, a trust that already has a loan to a company does not have to meet any special requirements. A trust that has a loan from a company is currently subject to division 7A within the company. When there is a taxable accumulation, consideration would have to be given as to whether loans between companies and trusts should be exempt from division 7A in whole or part (as company to company loans are fully exempt currently).

Ideally, you would want to structure the provisions in such a way that you could eliminate the need for Division 7Aea, and/or the ATO interpretation of "financial accommodation" problem (including their complex solutions including sub-trusts, 7 year or 10 year loans, etc, etc). However these issues may be largely irrelevant given the need of these structures will be eliminated if trusts become an accumulation vehicle.

Statutory Definition of Distributable Income and Other Features (Section 6.4.2 of Consultation Paper)

Section 6.4.2 of the consultation paper discusses the statutory definition of distributable income.

You could go further than just having a statutory definition of distributable income by also legislating other restrictions and definitions that could be contained in certain trust deeds. These could be set up as a set of "replaceable rules" similar to those the corporations act that companies currently can optionally use. These replaceable rules would contain statutory definitions as well as a statutory set of restrictions on the powers of a trust deed. They would be optional, however those trusts that adopt these replaceable rules could be subject to simpler provisions and enjoy particular exemptions.

A trust deed could refer in whole or part to the replaceable rules. For certain replaceable rules, such as the definition of distributable income, if there were a conflict between a clause in the trust deed and the replaceable rule chosen, then the replaceable rule would prevail.

For other replaceable rules, such as the required timing of a distribution, then the more restrictive clause would apply. The replaceable rule would serve to restrict the clause in the trust deed. Should the clause in the trust deed already be more restrictive than the replaceable rule, then the replaceable rule would have no effect.

Some suggested Replaceable Rules are as follows:

1. A statutory definition of distributable income.

2. The timing of when the trust distribution has to be determined by.

   There are legal opinions now that suggest a trust does not have to distribute <u>by</u> 30 June. Should the trust deed allow, it is argued that a distribution could be made after 30 June in relation to that financial year. The replaceable rule would cap that period to a specified period.

   For a trust that has elected to be a family trust, and/or a trust that is a small business entity, that period could be set as the lodgement date (or due date for lodgement) of the relevant income tax return. These types of smaller closely held family trusts are less likely to have users that require the relevant information to lodge their personal income tax return.

3. You could choose to eliminate the requirement for a family trust election and family trust distribution tax by instead using the replaceable rules to define the allowed beneficiaries in the trust deed. The beneficiaries would be restricted by provisions in the replaceable rules that are similar to the allowable beneficiaries that a family trusts election currently uses.

Trusts that use these replaceable rules in full could be considered as complying family trusts and be exempt from a number of provisions that currently are avoided by a Family Trust Election. By having a defined set of trust clauses and restrictions, it might also make it easier to allow other exemptions.

<u>Costs of Change</u>

With many of the above suggestions there will be a compliance costs for existing trusts to adapt to these rules. However I don't think we should limit the good design of a functional system for this reason alone. We are currently having a majority of our trust client's deeds reviewed and amended as required so that they can cope more readily with the changes enforced from the Tax Office's interpretation of the Bamford issues, and other matters.

Trusts rarely are able to cope with the complexities of our taxation system without the assistance of a tax agent or a solicitor. Any solution that comes out of this consultation process should not avoid simplification in the hope of avoiding a one-off cost to obtain advice and an amendment if required.

Conclusion

Having trusts that can function as accumulation vehicles does not necessarily solve a lot of the issues discussed in the consultation paper. However making this change can be done in addition to any other changes, and will actually result in a lot of smaller family trusts sidestepping a number of issues raised in the consultation paper, and others.

Any statutory definition of trust income should be optional, but can also include a number of other statutory definitions that can assist trustees, tax agents, lawyers and regulators.

Yours faithfully

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