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Dear General Manager

Treasury's apparent willingness to move promptly in an interim fashion on the uncertainties arising out division 6 in order to remove uncertainty is to applauded.

As a sole practitioner and as director of a small company that delivers in house tax training to firms of accountants we don't have the resources to address all the points raised in the consultation paper.

We have focused on some issues that others may not raise. We do so because of the level of contact we have with accounting firms right across Australia. In neither capacity do we sell trust deeds so we are not conflicted in that regard.

We note that the proposed measures cannot be discussed meaningfully without consideration of the impact of several divisions of the legislation:

- division 40, subdivisions F, G and H ;
- division 41 which was considered in the briefest of fashion;
- division 43;
- division 115 which has been considered;
- division 152;
- division 207 which has been considered;
- division 328.

There is no consideration of late lodgment penalties and other non deductible expenditure such as expenditure on entertainment. There is also no consideration of disregarded capital gains other than general concession, essential because not all disregarded capital gains are treated in the same manner by trust deeds.

Division 41 was considered in chapter 2 as follows:

> *Consideration will therefore need to be given to whether amounts such as franking credits and deemed dividends should be treated as notional income and therefore excluded from distributable income. In addition, consideration will need to be given to whether amounts such as new business investment assets under Division 41 of the ITAA 1997 should be treated as notional expenses and disregarded in calculating distributable income.*

In my view that similar consideration needs to be had of each of the divisions raised above.

The general approaches outlined in Chapter 2 to define the concept of 'distributable income

Many income reclassification clauses operate by default although I acknowledge that by failing to do something a trustee can force the default outcome. In my experience over twenty years nearly all trustees are ignorant of income reclassification clauses as are a majority of accountants.

At a recent tax discussion group attended by over twenty senior, technically up to date and well regarded practitioners only one had ever encountered the type of situation set out in example two of the consultation paper.

All in the room were of the view that Part IVA would apply to the circumstances set out in example 2. All understand that Part IVA is administratively too time costly for the ATO. All supported the concept of a special anti avoidance rule.

It is inexplicable in the context of example 2 that Treasury avoided addressing what the Full Federal Court said about reclassification in Forrest v Commissioner of Taxation [2010] FCAFC:

> *27 In our opinion, the power conferred by cl 12 cannot be exercised by the trustee wrongly to classify a receipt as a capital gain, when the receipt is, in truth, income, and thus deprive the appellant of his interest in the unit component of the trust. Clause 12 is not an unlimited power to be exercised in the trustee's unconfined discretion.*
>
> *28 The words used in cl 12 do not have the literal and broad meaning which the Tribunal gave to them. …Clause 12.1 is a power to make an honest administrative determination whether receipts are on capital account or income account. It is not a power to determine, in the trustee's unconfined discretion, whether a receipt "represents realised or unrealised capital gains". It is that fact which determines whether components of the trust fund are held on trust for the discretionary beneficiaries or the Unit Holders. (See the definitions of "Discretionary Component", "Fixed Income", and "Unit Component", and cl 3.2).*
>
> *29 Clause 12.2(a) is a power to determine how a distribution to beneficiaries is classified. That limited power is not a power which is capable of altering the beneficiaries' rights. Clause 12 is to be read consistently with the balance of the Trust Deed and an appreciation that it contains various powers of an administrative character. The words used can be given full force as a power honestly to classify income or distributions according to law, as the appellant contended to this Court.*
>
> *30 In our judgment, cl 3.2, together with the definitions, and the rights expressly conferred on the Unit Holder by cl 4, demonstrate that the settlor's and trustee's objective intention was that income other than capital gains was to be held on a fixed trust for the Unit Holders, and capital gains were to be held on a discretionary trust.*

If this consultation is to mean anything at all then a discussion about the impact of Forrest was essential. Perhaps it was simply overlooked.

Accountants do not need another measure of income. We must not apply the label "distributable income" to anything other than what that label currently measures (See Zeta Force) If the concept is to proceed Treasury must find a synonym or create wholesale confusion amongst those who are not as familiar with the various labels but who are responsible for the output.

The present interaction between the demands of a trust deed and the requirements of the tax system is inexplicable.

To appropriate the label "distributable income" in the manner suggested as potentially an interim measure borders on the irresponsible.

Currently trustees can be required to calculate annually several measures of "income":

- the income of the trust estate (distributable income) by whatever label which might be any of income, net income, Net Income or Income and which may or may not be defined;
- section 95 income (assessable income);
- ordinary income in the ordinary course of business for the purposes of division 328 in determining whether an entity is a small business entity etc;
- income for the purposes of division 152 see in particular the tests for connected with at section 152-30 etc;
- the income and the tax preferred amount of the trust concept that is required for a trustee to comply with its obligations under the Trustee Beneficiary Reporting rules.

This is an unsustainable situation. Treasury should be asking the extent to which those responsible for the tax returns of trusts are able to do all of the above or even know that all of the above are required. Treasury should then ask whether a name other than distributable income can be found.

Call that amount "Code Income" or "Divisible Receipts" or invent a name but do not use distributable income.

What accountants deal with are "receipts" whether those receipts be of income or capital. Either way it is a receipt. It is receipts that are recorded, it is receipts less expenses that become net income. Ultimately it is the character of the net receipts that generates a tax liability. Therein lies a problem because the tax system does not require expenses to be quarantined by the character of the receipt to which they are attributed. Tax outcomes can be changed by changing the allocation of an expense from an expense of income to an expense of capital. What should properly be a cost base item becomes a deductible expense by recharacterisation (whether or not the deed allows that to occur).

Why not start the process with the "receipt" rather than the end measure?

Whichever approach Treasury prefers in its attempts to cure the problems it has identified Treasury must consider the need for the convergence of the various measures or concepts identified so that there are just two measures to be considered for ALL of the matters identified above. I appreciate that this might not happen before the end of the current financial year.

That these issues have not been brought to Treasury attention doesn't mean they don't exist, they only mean that the people Treasury hear submissions from, mostly the big end of town legal and accounting firms, are unaware of impacts of the tax system on the majority of practices.

The proposed methods outlined in Chapter 3 regarding the streaming of franked distributions and capital gains.

In chapter 3 Treasury highlighted the approach taken by Stone J in *Colonial First State*[1] in relation to streaming but did not address the impact of her slice approach on the operation of the small business concession qualification provisions in division 152 and the connected with test in division 328.

This issue matters because the "connected with" test, which applies measures of income and capital, is fundamental to both the active asset test and the $6m net asset value test.

Treasury cannot better align the historical concept of distributable income and taxable income. What treasury can do is to ensure the correct taxation of receipts.

Treasury should:

- ♦ set out some expense matching rules; and
- ♦ tax receipts by origin or character, in the hands of the beneficiary; and
- ♦ put an end to reclassification by a specific avoidance measure perhaps based on the decision in Forrest.

Other questions

1. If income of the trust estate is defined according to tax concepts should the gross capital gain be included in income or only the net capital gain (after applying available discounts)?

See example 8 where Aaron is able to use up some of his capital losses under the current system.

2. Should all notional amounts (for example receipts or expenses) be excluded from a definition of distributable income based on the concept of taxable income, or are there some notional amounts that should be included?

Consistency of approach is essential – the current system is unsustainable as it is and any steps that simplify what is required are welcome, steps which make if more unworkable are to be deplored.

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?

If receipts are taxed in accordance with their essential character (dividends, rent, interest, trading profits, capital gains etc) specific anti avoidance rule will have application only to the cheats. In the main the books of account for a trust already show the receipts broken down by type.

5. Even if a specific anti avoidance provision were introduced to restrict the reclassification of trust amounts, would the distributable income of a trust still need to include any capital gains made by the trust to ensure that income beneficiaries are not taxed on capital gains that only benefit capital beneficiaries?

See the comments to paragraph 4 above, tax receipts by character.

Streaming of certain trust amounts

[1] *Colonial First State Investments Limited v Commissioner of Taxation* [2011] FCA 16.

7. Should Subdivision 115 C continue to apply after the application of Division 6 where there is a discrepancy between a beneficiary's entitlement to a capital gain included in the distributable income of the trust and the amount of the trust's net capital gain included in the beneficiary's assessable income?

The issues raised in relation to division 115 apply to the qualification provisions under division 152 and need attention in that context.

Yours faithfully

Chris Wallis