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

21 March 2011

Our Ref: GC/MM

By email: SBTR@treasury.gov.au

Dear Sir

Re: Submission regarding 'Improving the taxation of trust income' discussion paper

We welcome the opportunity to lodge a submission about the Discussion Paper regarding 'Improving the taxation of trust income'.

We commend the Government for what it is attempting to achieve and also for seeking advice from the Board of Taxation (BOT) as part of the process. In principle, we agree that the issues identified by the BOT do need to be addressed. However, the short timeframe in which the Government seeks to consult and implement the desired changes is unrealistic. Allowing only two weeks for stakeholders to fully consider the merits of the three nominated options or to suggest alternative options is totally insufficient and is not within the spirit of a public consultation process.

Any further major changes to the taxation of trusts should, as originally announced by the Assistant Treasurer on 16 December 2010 be the subject of a comprehensive review. Such a review should involve input from stakeholders over a much greater timeframe than the two week period afforded by Treasury in respect of the discussion paper.

We do not support any of the three options, because as the discussion paper acknowledges, these options either produce anomalous outcomes and or will be difficult to comply with, given the insufficient time available to understand any proposed change prior to its commencement. We have highlighted some of the more significant problems with each of the three options in Appendix A.

We cannot see any merit in replacing old problems with new problems as this will only exacerbate the problems by creating greater uncertainty.

In our view it would not be possible to design and implement amendments, (whichever of the proposed options is chosen), that would achieve the desired outcomes in sufficient time for trustees, accountants and tax advisers to have a working knowledge of the proposed changes before 30 June 2011.

The changes proposed in the discussion paper are not the only changes in tax law effecting trustees around 30 June 2011. For example, the TFN withholding measures for closely held trusts require trustees to fulfil certain reporting requirements by 31 July 2011. The ATO advised that the relevant form to complete their obligations will not be available until 1 July 2011. 30 June 2011 is also the deadline for certain unpaid present entitlements owing to corporate beneficiaries to be repaid, converted to a loan or put on a sub-trust in accordance with Practice Statement PS LA 2010/4.

The proposed changes are significant and will potentially affect in excess of 660,000 trusts. Making legislative changes of this nature prior to the announced comprehensive review is putting the cart before the horse and is likely to have a detrimental effect on the small and SME sectors who are the greatest users of trusts.

We have endured the anomalies that exist under the current law for decades. In the event that there are any legislative changes, those changes should create a system that works. The discussion paper acknowledges that we will continue to have anomalies under all of the proposed options, albeit perhaps different anomalies. The past has demonstrated that ad hoc amendments typically create more problems than they solve. The Ultimate Beneficiary Statement provisions are a classic example of this.

In light of all of the above, the proposed changes are likely to cause confusion rather than enabling trustees to continue to manage their affairs with confidence in the tax outcomes that apply to their circumstances.

Alternative Options

To achieve the Government's stated objectives during the interim period between now and the finalisation of a comprehensive review, we recommend the following option:

Alternative Option: Continue with past administrative practices

Capital Gains

We recommend that the Australian Taxation Office (ATO) reinstate its administrative practice as outlined in Practice Statement PS LA 2005/1 which deals with the streaming of capital gains under certain circumstances.

Under the (now withdrawn) practice statement, net capital gains can be allocated to one or more beneficiaries of a trust under the terms of a written agreement. The relevant beneficiaries are subject to tax on that gain regardless of how the term 'the income of the trust' is defined in the trust deed.

Trustees and tax agents are highly likely to have a working knowledge of PS LA 2005/1. Therefore the desire for confidence regarding the tax outcomes is achieved under the Practice Statement.

As for attempts to manipulate a trust's taxable income, the ATO ought to be able to apply Part IVA of the Income Tax Assessment Act 1936 to deny any tax benefit arising from a scheme which has, as its dominant purpose, the manipulation of a trust's distributable income in order to achieve the desired tax benefit.

Franked Dividends

Given that the discussion paper suggested that there is a degree of uncertainty about the way that Subdivision 207-B is intended to operate, the ATO could continue to administer the law as outlined in Taxation Ruling TR 92/13 which deals with the streaming of franked dividends.

Again, trustees and tax agents should be fully aware of the contents of TR 92/13.

From an integrity perspective, there are numerous anti-streaming provisions in existence which address any unintended consequences of streaming franked dividends.

Manipulation

Example 2 in the discussion paper provides an example of blatant manipulation. It would seem that it would only be in the rarest of circumstances that Part IVA would not apply to deny the tax benefit obtained via such a scheme.

Any specific anti-avoidance measure to deal directly with situations of tax avoidance in this way should also be considered as part of the announced comprehensive review of trusts.

We note that there is currently a review of anti-avoidance measures taking place, and therefore the need for any new anti-avoidance measure should rightly be part of that review.

Legislative Change

In the event that the ATO is only satisfied with a legislative change, we suggest that the ‘capital beneficiary approach’ as outlined in PS LA 2005/1 be legislated as trustees and tax agents are both familiar and understand the way the PS LA works.

Alternatively, the law could be amended to give the Commissioner a discretion to administer the law in accordance with PS LA 2005/1.

Streaming Classes of Income

We note that the discussion paper raises concerns about the ability to stream franked dividends and net capital gains to specific beneficiaries. In our view, any amendments should also address the streaming of other classes of income so that the various provisions of the *Income Tax Assessment Acts (ITAA)* interact properly. Examples of other classes of income are:

- Foreign income – particularly where foreign income tax offsets are attached or where foreign income is distributed to a non-resident beneficiary;
- Interest, dividend and royalty income – so that the withholding tax provisions interact properly;
- Trading income – so that timing differences between tax and accounting can be easily reconciled.

The ability to stream a class of income only came into doubt following the decision in *Federal Commissioner of Taxation v Bamford; Bamford v Federal Commissioner of Taxation HCA 10*. We note that the High Court was not asked to decide whether streaming was permissible under section 97 of the ITAA 1936. Nevertheless, there appears to be a degree of uncertainty regarding streaming.

We suggest that the issue could be simply resolved by amending section 97 to include a definition of the term ‘share’.

The High Court said that the term ‘share’, where it appeared for the second time in section 97(1) referred to proportion, rather than part or portion. To overcome the problem that this creates, ‘share’ could be defined to mean ‘a class of income’ where the trustee (under the terms of the trust deed) was either permitted or required to stream different classes of income to particular beneficiaries. Classes of income could be defined to include the following:

- Franked dividends
- Unfranked dividends
- Interest
- Royalties
- Notional capital gains or net capital gains
- Foreign income
- Trading income
- Exempt Income; and
- Other

Managed Investment Trust (MITs)

Many managed funds (irrespective of whether or not they meet the definition of a Managed Investment Trust) are likely to have a preference to continue with existing industry practice (notwithstanding the ATO’s view of the impact of the decisions in Bamford v FC of T; FC of T v Bamford 2010 HCA 10; and Colonial First State Investments Limited V Commissioner of Taxation [2011] FCA 16). For example, industry practice includes the ability for managed funds to apply the Trust Deed in determining distributable income, the ability to allocate income components to unitholders at interim distribution dates, and the ability to distribute capital gains to redeeming unitholders.

Any changes to generally accepted industry practice, separate from the already announced review of Managed Investment Trusts that has been announced to apply from 1 July 2011 (or a deferred date if announced), are likely to be difficult to implement and create further uncertainty/confusion in the managed funds industry in the interim.

Although many funds already use a taxable income definition (adjusted for notional credits such as franking) to good effect as a reference point for distribution policy, this cannot be assumed across the board, and thus simply mandating this definition is likely to result in a change to existing practice for certain funds.

As this requires analysis to consider all scenarios, which may not be possible within the time frame, it might be preferable if managed funds were given the choice to opt out from the changes, and continue with industry practice.

Questions For Consultation

Our responses to the specific questions posed by the discussion paper are in Appendix B.

We welcome the opportunity to discuss any aspect of our response in further detail. Please contact either Gary Christie on 03 9671 7180 or Moira Merrick on 03 9671 7309.

Yours sincerely

Gary Christie
Director
Deloitte Touche Tohmatsu Ltd

Appendix A: Discussion Paper Options

Option 1: Defining distributable income using tax concepts.

In our view, option one as outlined in the discussion paper is not a viable option as an interim measure. In its present form, numerous anomalies will inevitably arise because of mere timing differences. Drafting legislation that anticipates every conceivable timing difference is not possible in the proposed timeframe.

A number of problems have been identified with option 1. A problem will often arise when there is a disposal of real property or a business. This is because a CGT event arising from the disposal of such assets will typically be taken to have happened when the contract was entered into, whereas the change of ownership does not take place until the contract is settled. Ninety day settlements are not uncommon for the disposal of real property. Settlement of the sale of a business often takes much longer. Therefore, it will often be the case that these types of contracts straddle year end. This will create a timing difference between the distributable income for tax purposes and the distributable income for accounting purposes. The trustee will not be able to create a present entitlement to a net capital gain until the contract has settled. In this situation, the net capital gain would be assessable to the trustee under section 99A of the ITAA 1936 and, therefore, the CGT discount or the CGT small business concessions will not apply.

Problems with option 1 are not confined to the SME sector. Many managed funds use taxable income as a proxy for determining distributable income, but this is not applied consistently across the board and therefore, option 1 would not provide managed funds with a workable solution in all cases either.

Option 2: Defining distributable income using accounting concepts

Trustees are likely to assume that they will have to prepare accounts in accordance with accounting standards and therefore reject this option on the basis of increased compliance costs.

Option 3: Defining Distributable income to specifically include capital gains

Defining distributable income to include any capital gains is not likely to interact well with trust law. The fact that such an amendment would require a specific anti-avoidance provision is likely to result in unintended consequences. A change of this magnitude should be the subject of the announced comprehensive review of Division 6.

Appendix B

BETTER ALIGNING THE CONCEPTS OF DISTRIBUTABLE AND TAXABLE INCOME

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)?

   We do not agree with the proposition of defining the income of the trust as according to tax concepts. However, if this option is adopted then our view is to include the gross capital gain (rather than the discount capital gain) in the definition of the income of the trust estate. We say this because a beneficiary in receipt of a capital gain made by the trust has to gross up the gain to offset any of the beneficiary's own capital losses under section 115-215. It appears to be implicit in section 115-215 that there is an expectation that the beneficiary in this case would be entitled to the gross amount of the gain. It would, therefore, be preferable that the beneficiary is entitled to the gross capital gain. A further point is that for a beneficiary to benefit from the 50% CGT discount, the beneficiary should be entitled to the gross capital gain.

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?

   Because we do not agree with option 1, this question is not applicable. However we would consider this further as part of a comprehensive tax review regarding Division 6 of the ITAA 1936.

3. Would adjustments to the definition of distributable income also be needed where timing differences exist between the distributable income (as newly defined) and the trustee's calculation of 'income' pursuant to the terms of the trust deed? How could this be achieved?

   As above

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 think that Part IVA is sufficient at this point in time. In our view, it would be preferable to wait for the outcome of anti-avoidance provisions review, which is currently being undertaken before any decision regarding a specific anti-avoidance provision should be made. Alternatively, questions 4 and 5 could form part of that review.

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?

   As above in question 4

Streaming of certain trust amounts

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?

   Not at this point in time.

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?

   This question appears to be a bit ambiguous.

8. Instead of looking to amounts assessed to beneficiaries under Division 6, should Subdivision 115-C instead look to the trust entitlements of the beneficiaries?

   Intuitively, it would seem to be preferable for Subdivision 115-C to be directed at the beneficiary that is allocated the capital gain rather than at the amount included in a beneficiary's assessable income. However, we would need to see the proposed amendment and work through some practical examples before we could make appropriate comments.