

17 March 2011

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

MR BRADSHAW

Jtu
24/3

Messrs Coxson & Wilson

MB
24/3

Attention Mr Michael Bradshaw

Dear Sir

Submission for Improving the Taxation of Trust Income

Many thanks for providing us with the opportunity to make Submissions concerning the Discussion Paper on improving the Taxation of Trust Income.

Given the very general nature of the Discussion Paper, the following are broad comments on any proposed changes.

We applaud the notion that the income of a Trust Estate should be aligned to the taxable income of the Trust Estate and consider that concept to be a more workable concept of income of the Trust Estate than what currently exists in Division 6.

Income of the Trust Estate

Needless to say, broad and diversified "income" definitions currently exist within Trust Deeds generally. We put forward for further consideration the proposal that if a Trust Deed is amended to accommodate the *income* definition that is finally adopted within the Legislation, the Trustees or beneficiaries should not be exposed to any Capital Gains Tax or State Taxation for Stamp Duty merely by reason of amending the Trust Deed. This is especially so if the only change to the Deed is the definition (or include a definition) of a *income* so that the Trust Deed accords with the Legislation.

We accept that an alternative view is to legislate a definition of "income" in Division 6 that is consistent with Ordinary income rather than taxable income. We would accept either approach provided trust deeds could be amended to accommodate the change in legislation without a resettlement or other tax cost.

Our Submission in respect of this recommendation is:

1. Please include an exemption from Capital Gains Tax for amending Trust Deeds for the purpose of defining or redefining *income* of the Trust Estate in a manner consistent with the definition of *income* adopted by the amending Legislation;

2. Please discuss the proposed concept of *income* of the Trust Estate with the respective State Revenue Officers and State Treasurers to exercise their discretion under the respective Duties Acts to exempt from Stamp Duty amendments to Trust Deeds that amend the definition of *income*.

Streaming Generally

We agree with the concept that capital gains and dividends should be capable of being streamed. We consider though that streaming should not be confined to just capital gains and dividends but extend to other amounts such as foreign sourced income and capital gains, foreign income tax offsets and any other identifiable class of income.

Further, we submit that taxation legislation should permit the amendments of Trust Deeds to accommodate the legislative changes without the risk of resettlement and tax cost.

Capital Gains Tax

1. *Allow Trusts to accumulate Capital Gains and obtain the benefit of the 50% CGT Discount*

We agree with the Discussion Paper that capital gains should be streamed to capital beneficiaries under the Taxation Legislation. Further, we have no issue with any proposal to include an anti-avoidance provision to deal with re-definitions of amounts to be either income or capital if the purpose of the re-definition of the amount is to avoid tax.

We anticipate that a possible amendment might be to apply the "quantum" view of distributing income.

As a further alternative we request that the Government consider removing the "penalty" rate of tax under Section 99A if a Trust accumulates the capital gain and allow the trustee to have access to the 50% CGT discount if the capital gain is accumulated in the Trust.

By allowing a Trust to accumulate a capital gain and obtain the 50% CGT Discount, this would reduce the need for streaming a capital gain to an individual. It would simplify the compliance process and indeed the operation of the legislation. We point out that in many cases, the physical cash resources supporting that distribution are typically kept within the Trust and applied for further investment.

Consequently, as part of the "streaming" amendments, it may be of benefit to consider whether Trusts can accumulate capital gains and obtain the 50% CGT Discount.

As such, we submit that:

1. There be an amendment to the rates declared by Parliament that apply to amounts covered by Section 99A of the Income Tax Assessment Act 1936. Further, amendments to Section 115-225 of the Income Tax Assessment Act 1997 be considered to permit the accumulation of capital gains within Discretionary Trusts without a reversal of the 50% CGT Discount.
2. *Small Business Rollover Capital Gains Tax Concessions and Discretionary Trusts*

Currently, the integration of the Small Business Capital Gains Tax Concessions with Discretionary Trusts and Unit Trusts is a significant improvement over what existed prior to Division 152 and Division 115 but could go further.

In particular, if a Discretionary Trust chooses to apply the Small Business CGT Rollover, there is some tension as to whether the capital gain itself could actually be accumulated in the Discretionary Trust and the application of Section 115-225. This is particularly relevant to the Small Business CGT Rollover but also applies to the 15 Year Exemption and the Small Business Retirement Exemption.

In our view, Section 115-225 would have no application on an accumulation of a capital gain if no part of the capital gain is included in the definition of "income" of the Trust for the purposes of Division 6.

We request that the Government be mindful of these Concessions in amending the definition of *income* to enable capital gains with the Small Business CGT Rollover to remain within the Trust. Otherwise, a Discretionary Trust may be compelled to payout the capital gain when the nature of concession is such that the gain be retained in the Discretionary Trust and applied towards the acquisition of a new business by that Discretionary Trust. This would be the case in relation to the Small Business CGT Rollover concession

3. Small Business 15 Year Exemption and Retirement Exemption

Both exemptions provide the Trustee with the ability to satisfy the requirements if the respective amounts are paid to a CGT Concession Stakeholder/Significant Individual within a period of time that can be up to 2 years and in some cases longer. As such, any amendments that force a payment of the capital gain prior to the period of time prescribed by the concessions would be inconsistent with the current words of the exemption.

Further, we highlight the fact that amounts that are exempted under the 15 year exemption are non-exempt income.

Amounts that are not income under the revised definition.

In formulating an amended definition, thought should be given to the taxation amounts that are distributed that are not within the proposed definition of income. For instance, do they form part of the Trust's Corpus? What happens when those amounts are paid out? Will CGT Events E4 and CGT Events E5 apply to those "non income" amounts?

Currently, these "non income" amounts form part of trust corpus. When these amounts are paid out, they are potentially caught within the strict wording of Section 99B of the Income Tax Assessment Act 1936 and assessable in the hands of the recipient unless they meet one of the exceptions in Sub-section 99B(2). Key amongst those exceptions are amounts distributed from corpus.

Although the Commissioner has stated that he will only apply Section 99B in relation to non-Australian resident Trusts, any amendment should legislatively confirm the Commissioner's position concerning Section 99B.

In addition, when a non income amount is paid in respect of a unit in a unit trust, CGT Event E4 applies to adjust the Unit Cost base for CGT purposes and if there is no cost base, a capital gain may arise. There are exceptions to CGT Event E4 such as the payment of amounts that are non assessable by reason of the 50% CGT Discount.

CGT Event E5 applies to a discretionary trust where a beneficiary becomes absolutely entitled to an asset as against the trustee. Will an entitlement to these "non income" amounts represent an entitlement to an asset as against the trustee and resulting in CGT Event E5? Will they be caught by another CGT "E" Event or another event?

We recommend that further thought should be given as to which CGT Event should apply to amounts that are not within the amended definition of *income* to prevent the "reversing" of any concessions that are intended to be paid without further tax liability (such as amounts under the 15 year exemption or the amounts paid under the Small Business Retirement Exemption).

Anti-Avoidance

We note the intention of a Government to include an anti-avoidance provision to deal with re-classifications of income for a tax related purpose.

We point out that under the General Trust Law, a Trustee does not have to give reasons for the exercise of their powers and discretions under the terms of the Trust Deed. Further, Trustees generally do not state who would be alternative beneficiaries if the distribution failed.

In crafting any anti-avoidance provision, we would not be in favour of an anti-avoidance provision that applies where a different beneficiary may pay a low amount of tax or higher amount of tax than the beneficiary that ultimately received the distribution. Such anti-avoidance provision would effectively be potentially triggered in the case of every distribution made by a Trust.

It would make exercising trust powers more difficult and add to the compliance cost of operating a trust because a prudent trustee would be obliged to obtain tax advice about the anti avoidance provision just to make an ordinary trust distribution.

Hence, our submission is:

1. The application of any specific anti-avoidance provision proposed to be introduced into the Tax Legislation be confined to distributions to tax exempt entities and entities that may be prescribed by regulation.
2. Alternatively, the anti avoidance rules should be confined to situations where the recipient of the economic benefit of the distribution does not have an appropriate tax liability consistent with the recipient of the benefit. The reason why we have worded this submission in this manner is that if a tax exempt is paid the full value of the economic distribution in cash or property, we do not consider this to be a tax mischief.

Unpaid Present Entitlements

We note the Commissioner's position concerning unpaid present entitlements to beneficiaries in his various Practice Statements. In short, the Commissioner's view is that if a Trust distribution to a corporate beneficiary remains unpaid by the time the Trust lodges its Income Tax Return, that unpaid Trust distribution would be considered to be a loan for purposes of Division 7A.

Although it may be too much to ask of the Government to deal with this issue in this round of amendments, we request that any consequential amendments to Division 7A that arise as a result of the proposed amendments be "neutral" to the issues raised by the Commissioner of Taxation.

Ideally, we would like to see the tension between the Commissioner's interpretation of Division 7A and the position of Taxpayers concerning the correct legal position to be resolved. However, we acknowledge that trying to resolve that issue would unnecessarily delay the proposed amendments and ought to be addressed separately of this issue.

The Order of Allocation of Deductions and Outgoings Against Specific Types of Income

A frequent issue that arises in relation to Discretionary Trusts is the allocation of expenses against particular types of income. The issue could be illustrated as follows:

Trust A derives a \$1,000 capital gain and \$700 of fully franked dividends which have a \$300 imputation credit attached to it.

Trust A also incurs \$200 of outgoings in the administration of the Trust generally.

The Trustee of Trust A resolves to allocate the \$200 of expenses against the fully franked dividend income thereby reducing the amount of dividend income available for distribution to \$500.

The Trustee of Trust A resolves to distribute the net \$500 of fully franked dividends to Beneficiary X and the capital gain to Beneficiary Y.

Again, this may be an issue that is too complex for the Government to address with the proposed amendments. Nevertheless, this issue is linked to the Government's decision to allow streaming of capital gains and dividends.

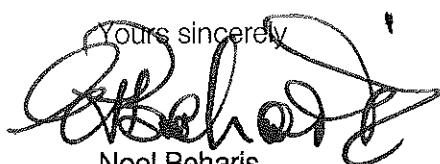
The above example highlights that the allocation of expenses against particular sources of income can alter the outcome of the distribution and how it is streamed. Most modern Trust Deeds allow the Trustees the discretion of determining what source of profit or income will be applied towards the payment of the Trust's outgoings.

Our view is that the Trustee's powers should be applied in the manner suggested. Alternatively, that if specific outgoings that are incurred to derive a particular source of income, those outgoings should be allocated against that source of income and general deductions allocated across all sources on a pro-rata basis.

We would not welcome any anti-avoidance provision that seeks to influence how expenses within the Trust be allocated except if they somehow advantage a Tax exempt beneficiary.

As such, we highlight this as an issue that the Government should consider if a final rewrite of Division 6 is incorporated into the Income Tax Assessment Act 1997.

We hope the above Submissions assist the Government in its deliberations and applaud its efforts in seeking to address this issue. Should you have any further queries in relation to this Submission or in relation to the rewrite generally, please contact Mr Noel Beharis or Mr Chris Hall of our office on 03 9607 6886.

Yours sincerely

Noel Beharis
Director, Tax Technical Services


Chris Hall
Director, Business Services