FSC FINANCIAL SERVICES COUNCIL

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General Manager
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Dear General Manager

DISCUSSION PAPER – IMPROVING THE TAXATION OF TRUST INCOME

The Financial Services Council ("*FSC*") welcomes the opportunity to comment on the Government's discussion paper regarding changes to the taxation of trust income.

The Financial Services Council represents Australia's retail and wholesale funds management businesses, superannuation funds, life insurers and financial advisory networks. The Council has over 130 members who are responsible for investing $1.8 trillion on behalf of more than 11 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalization of the Australian Stock Exchange and is the fourth largest pool of managed funds in the world. The Council promotes best practice for the financial services industry by setting mandatory Standards for its members and providing Guidance Notes to assist in operational efficiency.

The discussion paper deals with all forms of trusts and the issues of pertinence will vary depending upon the type of trust. Without intending to be exhaustive the FSC believes that there are six fundamental types of trust that are subject to Division 6. These are:

- Family discretionary trusts;
- Testamentary trusts;
- Unit trusts that do not qualify as Managed Investment Trusts;
- Managed Investment Trusts (MITs) (listed, unlisted and their related entities);
- Trust relationships under Investor Directed Portfolio services ("IDPS" or "Wraps"); and
- Trust relationships inherent in the use of a custodian.

When Division 6 was originally enabled the last three types of trust would not have been contemplated. It is in the context of the last three types that the FSC makes this submission.

Superannuation trusts have a separate code and need not be commented upon.

At the outset it should be noted that MITs will be the subject of a change of taxation regime in the near future. It is problematic to introduce a general change to Division 6 that will impact all trusts, have that apply to all MITs for one or two years and then introduce a new regime. The intervening step can only lead to uncertainty for MITs and their investors.

At 2.2.2 of the discussion paper it is suggested that an alternative approach would be to define distributable income with reference to accounting principles. We would oppose the use of such an approach for two reasons. Firstly, much of the uncertainty in this area has arisen because of attempts to reconcile the two concepts of "income of a trust estate" – a trust law concept and "net income" – a prescribed tax law concept. To add a third concept, that of accounting income, would only invite future reconciliation issues. Secondly, accounting income includes things that would never be recognised for tax purposes and has its own concept of timing. For example, many MITs routinely revalue their assets under "mark to market" arrangements. Such movements are booked in the accounts as income or expenses even though there has been no realisation. Interest income is recognised on an accruals basis for accounting purposes but for tax law only entities subject to the

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TOFA provisions would recognise accrued interest. To try and allow for these possibilities would be very complex. Accordingly, such a concept should not be introduced as a separate test even though the trust law concept heavily draws upon accounting principles.

For MITs a significant uncertainty that cannot be dealt with is the definition of “fixed trust”. A recent precedent has suggested an extremely narrow definition of that phrase. So narrow that it is unlikely that any MIT or listed entity in the country would constitute a “fixed trust”. It is possible to argue that the judge involved made an error in this regard on the basis that a literal approach was applied to a “saving clause”. However, such criticisms can only be academic. The fact is that the definition of “fixed trust” contained in schedule 2F of the *Income Tax Assessment Act 1936* cannot be met by any current MIT or listed trust. This definition is the foundation of a number of other tests and operations in the Tax Acts. The Government has previously announced that it will amend the law such that all MITs are deemed MITs but this will not happen until the above new regime is enacted. It is acknowledged the Commissioner has discretion to treat particular trusts as “fixed trusts”. However, this discretion has only been exercised rarely or if exercised has had very limited duration (e.g. some rulings have exercised the discretion for the period immediately before and after the making of CGT elections but not more generally). The Commissioner has more frequently refused to rule or had to be forced to rule using powers under the Taxation Administration Act. Indeed the Commissioner seems to be avoiding dealing with this area. This being the case the FSC does not believe there is an existing framework that will address this issue.

It is therefore essential that schedule 2F be modified so that entities which are for all practical intents and purposes fixed are so treated regardless of abstract theoretical possibilities. This is needed urgently because unless a trust is a fixed trust franking credits may not be capable of being passed through to beneficiaries. Were this clarification not to be provided, investors in managed funds will be severely disadvantaged.

If you have any questions regarding the FSC’s submission please do not hesitate to contact Pravin Madhanagopal or myself on (02) 9299 3022.

Yours sincerely

MARTIN CODINA
Director of Policy

Distributable income

The FSC believes that the current issues identified in examples 1, 2, 3 and 4 of the discussion paper stem not from a failure to align distributable income with the tax law concept of “taxable income”. Instead it flows from the way that proportions are determined – that is based upon trust income- and then applied to the tax income to which present entitlement exists. A more robust approach would be for proportions to be based upon amounts to which present entitlement exists rather than a theoretical entitlement. If an entitlement truly does not exist then ‘present entitlement’ should not arise.

> Section 97(1)
> Subject to Division 6D, where a beneficiary of a trust estate who is not under any legal disability is **presently entitled to a share of the income of the trust estate**:
>
> **(a)** the assessable income of the beneficiary shall include:
>
> **(i)** so much of that share of **the net income of the trust estate** as is attributable to a period when the beneficiary was a resident; [Emphasis added].

Equating *distributable income* with *tax income* has a simplistic attractiveness. However, there may be instances where this is contrary to the intention of the settlor of the trust. There are three different styles of trust potentially impacted by any change. Firstly, there are Collective Investment Vehicles (CIVs) and MITs, secondly there are discretionary trusts and thirdly there are trusts which are essentially fixed but which have different classes of beneficiary for income and capital. There is a significant possibility of getting any new rules right for some of these three categories but creating difficulties for the others. Even within the category of MITs there can be differences.

Even if distributable income is deemed to be equal to taxable income there will be a need to allow for express contrary intention in the trust deed. For example, many property trusts have trust law income that exceeds tax income due to specific tax incentives such as Division 43. Typically such trusts will distribute an amount in excess of their tax income, the excess being identified as *‘tax deferred income”. Tax deferred* in that whilst the amount is not immediately subject to income tax it will reduce the cost base of the investor’s asset and this ultimately is likely to result in a larger taxable certified gain on disposal. Another instance of this is the discount available on some capital gains.

A further example of where problems will emerge if the deed is ignored is where there are two types of beneficiary, those entitled to capital and those entitled to income. Under recent amendments MITs have been allowed to elect that certain profits are on capital account for tax purposes. The absence of such an election could mean the relevant assets are on revenue account – again a somewhat controversial area – does the presence or absence of an election overrule the intent of the deed?

Bamfords case unequivocally establishes that it is the trust deed that determines a beneficiary’s entitlement. Any tax change needs to take into account the deed. To not do so is to suggest that a theoretical abstract, not supported by the facts, should dictate taxation liability. Ultimately the tax law must start from the entitlements of the deed and operate to assign liability from there.

In summary any proposed change should not apply to MITs, registered schemes and listed trusts. These types of trust should continue to operate under the existing Division 6 until the proposed CIV/MIT Regime reforms are implemented. In this regard it should be noted that for over a decade the FSC and its predecessor body, IFSA, have been calling for a separate tax regime for CIVs in order that concerns in the general trust space can be specifically targeted.

The paper correctly identifies the need to address notional amounts such as arise from franking and capital gains discounts. We draw your attention to the need to also address foreign tax offsets too. It is suggested that a better approach is for beneficiaries to be required to include “gross up amounts” in income rather than the trust itself. This will eliminate many difficulties.

It may be the case that a trustee has distributed what it believes to be all of the net income of a trust and subsequent to year end additional net income is identified or some form of amended assessment issued. This could happen due to error, unidentified income or invalid expenses. In this instance the appropriate treatment of the additional income needs to be considered. It is suggested that if previously all net income was distributed then the additional income should be treated as

similarly distributed and the relevant beneficiaries would pay appropriate tax. This would be a more realistic outcome than that achieved by seeking to impose tax pursuant to section 99A of the ITAA 1936. An exception to this rule may be necessary for MITs if codification of the existing “over and under” is introduced.

Streaming

The FSC believes there are at least two types of streaming situations. Firstly, where the constitution permits. Secondly, where the constitution does not permit we agree with the proportionate approach of *Bamford* and other cases.

The FSC agrees with the fundamental principles that CGT discounts, franking credits and foreign tax offsets should be limited to the beneficiary entitled to the relevant part of a distribution. However, it would be a misnomer to say that this can only be achieving using some proportional methodology.

The FSC is also concerned as to what is considered to be streaming. The Board of Tax has previously acknowledged the need for flexibility in the trust area.

The FSC believes that if the trust deed allows for the trustee to classify and segregate different classes of income or capital then such classes should be capable of distribution to particular beneficiaries along with the tax attributes of those classes.

Consider the following example:

A property trust with ten investors owns ten buildings. One investor wishes to exit the trust. The trustee sells one building to fund the redemption payment and as permitted under the trust deed, allocates all of the taxable capital gains and appropriate proceeds to the redeeming unit holder. All other income of the trust is distributed proportionately amongst the ten. The fund also derives a small capital gain on the sale of depreciable assets for greater than cost. This gain is distributed proportionately among the ten. In this instance it is appropriate for taxation purposes for the large capital gain to be only included in the taxable income of the redeeming unit holder. Such a distribution is motivated by equity issues and fiduciary concerns. Hence, it is not motivated by a tax planning objective.

The FSC submits that if a beneficiary has received a distribution then that should be determinative of their present entitlement to that net income [tax income] of the trust.

Sometimes a trustee will be able to distribute specific income and gains within the financial year. However, more commonly, the trustee will wait until year end, arrange for the trust’s tax income to be determined and then make appropriate distributions. An argument exists that the beneficiaries would not be presently entitled to such a distribution as entitlement arose outside the financial year. An administrative practice has existed for many years of accepting the validity of such distributions provided they are made within three months of year end. The three months rule can be seen within the withholding tax provisions for MITs; sub-division 12H of the Tax Administration Act.

Any revisions to Section 6 should expressly confirm the validity of distributions within three months of the year end. To not make such amendments neuters the changes proposed in the discussion paper as “present entitlement does not exist”. An instance of where such an argument was made can be found in *Colonial First State Investments Limited v. FCT* [2011] FCA 16.

Other issues

Following the revisions suggested in the discussion paper it is likely that many trustees will seek to amend the deeds or constitutions of trusts they administer. The question of what is, or is not, a trust resettlement is a vexed one. It is submitted that in parallel with these measures it is appropriate to include a change to the tax law to the effect that revisions to deeds or constitutions as a consequence of these reforms do not amount to revenue or CGT events. This is particularly relevant given the Commissioner is seeking to appeal *Clarks* case. Additionally, Stamp Duty relief will be required.

IDPS / Custodian Arrangements

The current Division 6 does not deal well with situations where all beneficial interest is held by one party and legal title rests with another. Various parties take different positions as to whether such trusts have any existence for income tax purposes at all. The concept of absolute entitlement exists within the CGT environment but is absent from Division 6. The amendments proposed provide an opportunity to address this deficiency. This opportunity should be taken as some parties have postulated curious outcomes of such arrangements.

It is suggested that Division 6 be amended to include within it a specific reference to absolute entitlements. For example an amendment as follows could be made.

Section 97(4). Where a beneficiary is absolutely entitled to all income and property of a trust then that beneficiary is deemed to be presently entitled to all net income of the trust.

This means that beneficiaries would be presently entitles to all the income of the IDPS or custody arrangement.

Specific Questions raised in the discussion paper.

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

    A. It is the FSC's view that gross capital gain should be included after allowing for any current year or prior year capital losses. To only include net capital gains would cause complications in respect of the cost base amendments made in section 104 – 70(1). Those amendments ensured that the non-taxable component [the discount concession] of a distributed capital gain did not rise to an "E4 event".

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

    A. Notional amounts such as franking credits and foreign tax gross ups should be limited to the beneficiaries' taxable incomes. Complications arise too often from the concept of notional trust income. The discount on capital gains is an exception to this general principle.

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?

    A. If the new rules deemed distributable income to be equal to tax income then this should automatically address the issue of differences in the timing of recognition of income and expenses. However, the existence of a difference is not particularly problematic. For companies accounting income and tax income varies frequently yet seldom gives rise to a problem in determining the "net income" of the company for tax purposes.

       It should also be noted that many MITs make interim distributions throughout the financial year. These distributions should be treated as part of amounts that are required to be distributed to presently entitled beneficiaries.

       Particular attention needs to be given to the case of those investors whose entitlements are considered to be in revenue account in order to avoid double taxation.

       After all what could give rise to greater present entitlement then actually receiving a payment?

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?

A. Reclassification clauses are currently required because of differences between trust income and net income and perceived difficulties with streaming. If distributable income is made identical to net income, with or without allowance for the trust deed, and streaming is recognised then the role of reclassification clauses becomes redundant. Hence a specific anti avoidance measure would not be required.

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?

   A. If distributable income is defined as meaning net income for tax purposes then necessarily it will include net capital gains. The focus should be on whether present entitlement to that net income truly exists. Such present entitlement being demonstrated by actual distributions or specific resolutions followed by actual distributions at a later date.

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?

   A. The meaning of "fixed trust" needs to be corrected. The fact that this term is ambiguous has been known ever since Schedule 2F was enacted. In the absence of correcting this longstanding deficiency there is no point in altering s. 207 -35.

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 capital gains 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?

   A. Although complex subdivision 115C, as amended, does deal with net capital gains passing through trusts to beneficiaries. If distributable income is equated with net income for tax purposes there is no reason for change. The implication in the question is that there may be parties who are "presently entitled" to capital gains that form part of net income who are not truly entitled in an economic or commercial sense to the benefits of that capital gain. If this is the case then the question should be what does *present entitlement* mean? If a particular beneficiary has no immediate, or soon to arise entitlement, to a particular income or gain amount as determined by the principles of equity then it would be appropriate to say that "present entitlement " does not exist. A more rigorous test of present entitlement is likely to overcome situations such as identified in example 2 where a party ostensibly has the taxable income but in fact will never truly participate in that income.

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?

   A. See the answer to 7.