



Grant Thornton

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General Manager
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The Treasury
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Dear Michael

IMPROVING THE TAXATION OF TRUST INCOME DISCUSSION PAPER MARCH 2011

Dear Sir

We refer to the Australian Government discussion paper on *Improving the Taxation of Trust Income* and write to offer our comments and feedback below.

About us

Grant Thornton Australia is a leading audit, tax and business advisory firm dedicated to serving the needs of privately held and larger corporate businesses. We are strongly placed to comment on an array of issues affecting privately held businesses, including the taxation of trusts and trust income.

As a member firm of Grant Thornton International we are able to combine the knowledge and experience of our local marketplace with the technologies, methodologies and specialist resources of a professional service organisation at the forefront of the global accounting profession.

Possible approaches to better align distributable income and taxable income

The Government's paper outlines three possible approaches to better align trust distributable income and taxable income.

The main focus appears to be to ensure that capital gains are included in distributable income and that franked dividends and franking credits are appropriately taxed to the beneficiaries who receive them. We agree that these are the key issues given that Division 6 of the Income Tax Assessment Act has not been updated since the introduction of capital gains tax or dividend imputation.

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In our view, there is less need for reform to address other differences between distributable income and taxable income which are otherwise dealt with under the proportionate approach. We have discussed this further below.

In light of the above, we prefer an approach of defining distributable income to specifically include capital gains as noted below. An alternative approach we consider workable would be to introduce a specific anti avoidance rule into Division 6. In either case the change should be supplemented by the Government's intended amendments in relation to franked dividends and franking credits.

Our comments on each of the proposed methods considered by Treasury follow below.

Defining distributable income using tax concepts

We are not in favour of aligning distributable income with the net income (taxable income) of the trust.

The main reason for this is that there are often significant differences between the income available to distribute to beneficiaries and the taxable income of the trust. For example, consider a trust carrying on a small manufacturing business which has an operating profit of \$200K after expensing annual leave provisions and non-deductible legal expenses totalling \$50K. In that scenario, the trustee will only have \$200,000 available to distribute to beneficiaries but the taxable income of the trust would be \$250,000.

If distributable income is aligned to net income (taxable income) the trustee would be regarded as having \$250,000 of distributable income. This would mean that the trustee would need to distribute \$250,000 in which case the trust would go into deficiency. The alternative is that the trustee would only distribute the \$200,000 it has available in which case the trustee may incur a tax liability on the remaining \$50,000 at top marginal tax rates. This would lead to an unfair and unjust outcome, particularly if the trust has limited assets to call upon to meet the tax payable.

The outcome would even be worse for trusts that have differing income and capital beneficiaries, as the trustee may inevitably be required to draw from trust capital (to the detriment of the capital beneficiaries) to pay the tax if permitted by the trust deed.

Similar issues would arise in relation to franking credits which are included in net income (taxable income) of the trust but which do not provide cash which the trustee can distribute to beneficiaries. We agree with the potential suggestion on page 10 of the Government's paper that franking credits and deemed dividends should be treated as notional income and therefore excluded, if distributable income were defined using tax concepts. There is also the issue of dealing with exempt income and non-assessable non-exempt income as also acknowledged in the Government's paper.

Overall, we are not in favour of defining distributable income using tax concepts. In our view, it will result in unnecessary and unfair tax burdens for trustees and beneficiaries as

highlighted in the examples above. In our view the fundamental issues of appropriately taxing capital gains and franked dividends can be more readily addressed in other ways as discussed further below.

Defining distributable income using accounting concepts

We are also not in favour of defining distributable income using accounting concepts for the reasons outlined below.

Most importantly, trusts are established to provide certain income entitlements to beneficiaries based on the intentions of the settlor as outlined in the relevant trust deed. If distributable income is to be determined using accounting concepts, it will not always be consistent with the intention of the settlor or the provisions of the trust deed. Accounting concepts should not impact beneficiaries' entitlements to trust income.

By way of example, assume distributable income of a trust in accordance with the trust deed of \$100,000. However, in applying generally accepted accounting principles (GAAPs) the distributable income is increased to \$120,000. If the trustee fails to distribute \$120,000 it would be anticipated that a tax liability would arise in the trust under the proportionate approach and the top marginal rate would apply. However based on the trust deed the trustee only has \$100,000 available for distribution.

In our view, defining distributable income using accounting concepts will result in anomalous outcomes and put pressure on trustees to align income distributions with accounting concepts in a way which is inconsistent with the trust deed to avoid unintended tax outcomes. Once again, in our view there is a better way to deal with the key issues of taxing capital gains and franked dividends as outlined below.

We agree with the Government's comments that requiring all trustees to apply GAAPs would result in increased complexity and compliance costs. In our view, there is also a significant risk that tax outcomes could be manipulated through interpretation of GAAPs. Taxpayers may seek to manipulate tax outcomes by manipulating the interpretation and application of GAAPs creating a new set of challenges and uncertainties.

Overall, we are not in favour of this approach for the reasons outlined above.

Defining distributable income to specifically include capital gains

The Government's paper also canvases the possibility of defining distributable income to specifically include capital gains. Together with the proposed amendments in relation to franked distributions we are generally supportive of this approach although we note that it would require a very significant change that would impact thousands of taxpayers.

In particular, we agree that distributable income could be defined to specifically include capital gains and franked dividends. Franking credits should be excluded as a notional amount. This would mean that trustees would need to distribute capital gains and franked

dividends and the beneficiaries who receive those amounts would bear the appropriate tax liability. Amounts retained in the trust (if any) would be taxed to the trustee.

Following this approach, the sort of manipulation envisaged in example 2 quoted on page 5 of the Government's paper would not be possible. Referring to example 2, the trust would have \$100,000 of distributable income. Assuming that the charity was entitled to \$5,000 and Adam was entitled to \$95,000, each would recognise their share of the taxable income and Adam would pay tax on \$95,000. The charity would receive \$5,000 and that amount would be tax exempt which is an appropriate and intended outcome in the circumstances.

Overall, provided capital gains are included in distributable income, it means that the beneficiary who receives the benefit of the capital gain will be taxed on it and taxpayers will not be able to manipulate the tax treatment of capital gains via income distributions to charitable beneficiaries.

We note that including capital gains in distributable income would also eliminate situations in which capital gains can be trapped in trusts (and taxed at the top marginal tax rate) because of a lack of any distributable income under the deed. In that way another unfair and anomalous outcome could be avoided.

We do not understand the Government's comments around the need for a specific anti-avoidance provision to prevent manipulation. In our view, if capital gains are included in distributable income, then the beneficiary who receives the distribution must be taxed and therefore there should not be opportunities for manipulation. Please don't hesitate to contact the writer if you would like to discuss this matter further.

The Government's paper indicates that by only adjusting the distributable income to include capital gains, there will still be unfair tax outcomes. This is true in that taxable income may be different to distributable income due to timing differences in which case beneficiaries may have tax liabilities on amounts that are greater or less than their cash entitlements. This is accepted and has always been the case following the proportionate approach to taxing trust income.

In our view, eliminating this difference between distributable income and taxable income creates greater problems. As discussed above, where taxable income is greater than distributable income, either the trustee would be forced to distribute the excess putting the trust into deficiency, or the trustee would have a tax liability at the top marginal rate on the undistributed amount, neither of which is fair or intended.

On that basis, in our view, the changes to the tax treatment of trusts should largely be confined to ensuring the appropriate tax treatment of capital gains, franked dividends and franking credits. In our view, this would achieve the key objectives of the Government without creating unnecessary compliance costs, complexities or other disadvantages in the trusts are treated as outlined in our feedback above.

Alternative approach – anti-avoidance provision

Question 5 on page 19 of the Government's paper alludes to an alternate approach involving the introduction of a specific anti-avoidance provision. If such a provision were introduced, it may not be necessary to specifically define distributable income in Division 6. The Government could then rely on the anti-avoidance provision in situations of manipulation of the type outlined in its example 2. Complimentary amendments could also be made to clarify the tax treatment of franked dividends and franking credits.

The benefits of this approach would be that the Government should be able to eliminate opportunities for taxpayers to manipulate income and capital gains in order to avoid tax on capital gains as outlined in example 2. The issues concerning franked dividends and franking credits could be readily addressed by implementing the Government's specific proposals in that area.

It would then not be necessary to create a new definition of distributable income which would result in new uncertainty, complexity and compliance costs for all taxpayers, the very vast majority of which are not involved in situations designed to manipulate tax outcomes. The introduction of the specific anti-avoidance provision would therefore target taxpayers engaged in those practises and not create additional complexity for all others. There has been such a great deal of uncertainty concerning to the tax treatment of trusts in recent years. Avoiding further complex changes that impact a huge number of taxpayers should be preferred.

The anti-avoidance provision would presumably be relatively simple to draft in that it would have broad application and it would be a stand alone provision within Division 6, not requiring an overall rewrite or substantial amendment to the existing provisions. It is therefore submitted that this is a viable alternative to the more specific approaches suggested by the Government in its paper.

On the other hand, in the event that the Government decides, for example, to specifically include capital gains in distributable income, then in our view there is no need for a specific anti-avoidance provision as also discussed above.

Trusts without distributable income

Another anomaly in the tax treatment of trusts arises where a trust has taxable income, but no distributable income. In that case because there are no distributions to beneficiaries the trustee is inevitably taxed in the trust at the top marginal rate.

While we accept that this is a reasonable default position, we recommend consideration of a mechanism for the trustee to allocate the tax liability amongst nominated beneficiaries who agree in writing. A similar approach has previously been adopted by the ATO in relation to the tax treatment of capital gains in Practice Statement PSLA 2005/1.

Other issues

In terms of other issues, we note the following:

- The Government's paper intends to make it clear that capital gains and franked dividends can be streamed to beneficiaries. We suggest that similar consideration be given to foreign income as it also has specific tax treatment and may have associated foreign tax credits.
- Question 3 on page 19 of the Government's paper questions the need for adjustments to distributable income in relation to timing differences. We have discussed this above and believe that adjusting distributable income to incorporate timing differences creates other disadvantages such as trustees distributing income in excess of cash available (creating trust deficiencies) and trustees having tax liabilities at the top marginal rate on undistributed amounts in excess of the cash available for distribution. This is discussed in detail in our response above. On that basis we would not recommend that distributable income be defined in a way that incorporates timing differences.

Conclusion

Overall, for reasons discussed in detail above, we recommend either:

- Distributable income be defined to include capital gains and exclude notional amounts such as franking credits; or
- A specific anti-avoidance provision be included in Division 6 to prevent taxpayers manipulating the tax treatment of capital gains.

A range of other observations, comments and recommendations are also covered throughout our paper.

We congratulate the Government on its thoughtful and pragmatic paper on the issue of improving the taxation of trust income and look forward to watching developments with interest. If you would like to discuss our comments and feedback, please don't hesitate to contact the writer on 03 8663 6283.

Yours faithfully

GRANT THORNTON AUSTRALIA LIMITED



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