



18 March 2011

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

Dear Sir

RE: Improving the taxation of trust income

Thank you for the opportunity to provide comment on this recently released discussion paper. The Hayes Knight group of accounting firms provide a significant amount of taxation advice to SMEs throughout Australia and we also provide advice to a large number of other accounting firms through the support service we operate. The use and operation of trust structures and the taxation of their distributions are significant considerations for this market segment.

Without seeking to comment on all the implications of the proposals in the discussion paper, we want to raise a number of issues where we consider there is a lack of clarity or where there may be unreasonable consequences flowing from the proposed approaches in relation to the taxation of trust income.

1. Possible approaches to better align distributable income and taxable income

Set out below are our comments on the three general approaches outlined in the discussion paper with respect to better aligning the term 'income of the trust estate' (ie, distributable income) with taxable income for the purpose of section 97 of the *Income Tax Assessment Act 1936* (ITAA 1936) .

1.1 Defining distributable income using tax concepts

The first approach outlined in the discussion paper equates the definition of 'distributable income' to that of 'net income of the trust estate' as defined in section 95 ITAA 1936. This approach would apply for the purpose of section 97 regardless of how trust income is defined in the trust deed.

While we understand that this approach does have some advantages as outlined on page 9 of the discussion paper, there are some significant practical implications that would reduce the effectiveness of this approach in practice.

On page 10 of the discussion paper it is noted that a number of adjustments would need to be made in order to take into account 'notional' income and expense amounts such as franking credits, deemed dividends and 'investment allowance' deductions under Division 41 of the *Income Tax Assessment Act 1997* (ITAA 1997).

While factoring in adjustments to the trusts taxable income calculation would better reflect the actual amount available for distribution to beneficiaries, this would also lead to an increase in the compliance burden on trustees as they would need to prepare a separate distributable income calculation that may be different to all of the following:

- The profit figure in the financial statements prepared for the trust;
- The trust's taxable income calculation; and
- The calculation of trust income in accordance with the trust deed.

As a result, this approach could potentially impose a significant compliance burden on clients in the SME space.

1.2 Defining distributable income using accounting concepts

The second proposed approach equates the definition of 'distributable surplus' to that of accounting profit as determined in accordance with generally accepted accounting principles (GAAP).

This approach would also impose a significant compliance burden on clients in the SME space. Even though trustees would typically apply general accounting principles to determine the financial position of the trust estate, trusts in the SME space are often not reporting entities and are not required to apply all accounting standards when preparing financial reports and statements. Hence, applying this approach could potentially increase the compliance burden on a large number of trustees.

A similar problem has been experienced by SMEs with respect to the recent changes to section 254T of the *Corporations Act 2001*. Under the rules that apply from 28 June 2010, a company cannot pay a dividend unless its assets exceed its liabilities immediately before the dividend is declared and the excess is sufficient for the payment of the dividend. The assets and liabilities of the company are to be calculated in accordance with accounting standards in force at the time of declaring the dividend. This is the case even if the standards do not otherwise apply to the company in that financial year and can lead to a significant compliance burden on SMEs in particular.

Also, this approach may provide inappropriate results from a tax perspective under the proportionate approach as the accounting profit of a trust may be significantly different to its taxable income.

1.3 Including capital gains in distributable income

The third proposed approach allows the trust deed to determine 'distributable income' for the purposes of applying section 97 but only if the trust deed includes any capital gains made by the trust in distributable income.

Our view is that this approach appears to avoid the increase in compliance costs that would often be associated with the first and second approaches, particularly for trustees in the SME space. This is because the definition of distributable income for section 97 purposes would be closely aligned with the calculation of the distributable income that would already have been determined by the trustee in accordance with the trust deed.

Also, this approach should ensure that the tax liability for beneficiaries calculated under the proportionate approach is better aligned with the income to which they are presently entitled under trust law for the particular income year.

2. Streaming of franked distributions and net capital gains

We have no specific comments in relation to section 3 of the discussion paper.

The principles underlying the proposed legislative amendments with respect to franking credits and net capital gains appear to be sensible and should clarify the tax position for both trustees and beneficiaries. These changes should also ensure that the tax outcome better reflects the amounts of trust income and capital to which the beneficiaries are presently entitled under trust law. Even though the discussion paper mentions that this may be a potential issue, clarification needs to be provided in relation to the differing outcomes under the definitions proposed above. We have set out below an example to illustrate the practical implications.

Example 1

A trust deed does not define trust income under the deed to include capital gains and does not define income at taxable income. The definition of distributable surplus would not include the franking credits gross up amount. The following amounts were the income and expenses of the trust:

	Accounting income	Taxable income
Franked dividend income	\$70,000	\$70,000
Franking credits "gross up"		\$30,000
Interest expense	(\$80,000)	(\$80,000)
Profit	(\$10,000)	\$20,000

In this situation, there is no accounting income and hence no distributable income under the trust deed, in this situation, the trustee would otherwise be taxed on the taxable income. The position needs to be clarified as to how the franking credits would be streamed in this situation. Under the 'taxable income' definition of distributable income, these franking credits should be distributed to the beneficiaries based on their proportion of distributable income.

Example 2

Assume the same facts above, the trust also made a capital gain of \$15,000, per the trust deed could be distributed to a beneficiary, as follows:

	Accounting income	Taxable income
Franked dividend income	\$70,000	\$70,000
Franking credits "gross up"		\$30,000
Capital gain	\$15,000	\$15,000
Interest expense	(\$80,000)	(\$80,000)
Profit	\$5,000	\$35,000

In this situation, there is no distributable income based on the definition of distributable income in the trust deed, however, there is a capital distribution made to the capital beneficiary. Clarification needs to be provided in relation to treatment of the franking credits in this situation. Is this distributed in accordance with the proportion of amounts distributed to the capital beneficiaries or would it be retained in the trust.

3. Other comments

While we understand that the Government plans to release a separate discussion paper dealing with broader issues for improving the taxation of trust income, we would like to take this opportunity to make the following general comments as they relate to the issues discussed above.

3.1 Streaming of income

Clarification is required in relation to streaming of income and the impact of streaming on applicable tax laws. The discussion paper only seeks to address issues associated with the streaming of franked dividends and capital gains but clarification is required on how the tax law applies to other forms of income that have been streamed to specific beneficiaries such as:

- Foreign sourced income;
- Interest income; and
- Royalty income.

In particular, there is considerable uncertainty around the application of the following rules with respect to income that has been streamed to specific beneficiaries:

- The practical application of the proportionate approach to section 97 as confirmed by the *Bamford* case; and
- The non-resident withholding tax rules that apply in respect of unfranked dividends, interest and royalties.

3.2 Allocation of expenses

Clarification is also required in relation to the allocation of expenses of a trust across different classes of income for tax purposes. There is a lack of guidance and clarity on what constitutes a reasonable allocation of trust expenses when trust income is being divided into different sources for the purposes of streaming, especially when certain expenses are not directly attributable to deriving a specific form of income (eg, accounting fees).

Also, the Australian Taxation Office has indicated that Taxation Ruling 92/13 will be withdrawn. This ruling discusses the distribution of dividend income by trustees and attribution of expenses to particular classes of income for tax purposes.

3.3 Impact on other areas of the tax law

While this list is not intended to be exhaustive, we have set out below some examples of other areas of the tax law that require clarification with respect to trust distributions and the meaning of trust income and capital:

- Division 328 ITAA 1997: when determining whether an entity controls a discretionary trust it is necessary to consider the percentage of trust income or capital paid or applied to that entity.
- Division 152 ITAA 1997: when determining whether an entity is a CGT concession stakeholder or significant individual of a non-fixed trust for the purposes of the small business CGT concessions it is necessary to consider the percentage of distributions of income and/or capital to which the entity was beneficially entitled.
- Subdivision 269-D of Schedule 2F ITAA 1936: when determining whether a trust passes the “pattern of distributions” test it is necessary to consider the share of distributions of income and capital that have been made to individuals.

In each of the examples above the law requires clarification as to whether the terms “income” and “capital” refer to income or capital as determined in accordance with the trust deed or with reference to ordinary concepts.

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Thank you for your consideration of this submission. Should you have any queries then please do not hesitate to contact me at Michael.Carruthers@hayesknight.com.au.

Yours faithfully



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On behalf of the Hayes Knight Group