21 March 2011

The General Manager
Business Tax Division
The Treasury
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CANBERRA ACT 2600

By email: SBTR@treasury.gov.au

Dear Sir / Madam

Improving the taxation of trust income

The Institute of Chartered Accountants in Australia, CPA Australia and the National Institute of Accountants (the **Joint Accounting Bodies**) welcome the opportunity to provide a submission on the Discussion Paper titled “Improving the taxation of trust income” (the **Discussion Paper**).

Our comments contained in the attached submission take into account the issues discussed with Treasury and the Australian Taxation Office (**ATO**) at the consultation meeting held on 16 March 2011. In summary:

1. We welcome the initiative of the Government to address short term concerns with the taxation of trusts, prior to the review of the trust provisions contained in Division 6 of the Income Tax Assessment Act (the **ITAA 1936**) and their re-write into the Income Tax Assessment Act 1997 (the **ITAA 1997**). The Assistant Treasurer, the Hon Bill Shorten MP, has stated that the objective of this short-term review is to ensure that businesses and individuals using trusts can continue to do so with confidence and certainty in the short term.

2. Given that we are well into March 2011, that limited consultation has occurred on these proposals, that trust issues are very complex, and that differences between trusts are significant and unknown, we cannot support the proposal to mandatorily change the definition of income of the trust as a temporary resolution to certain trust issues. Accordingly, we can only support appropriate changes to the meaning of income of the trust if they are applied on an elective basis.

3. According to the most recently published statistics by the ATO[1], in excess of 660,000 trusts lodged tax returns for the 2007/08 income year. Of this figure, approximately 630,000 were discretionary trusts, deceased estates or non-fixed trusts. There is a lack of uniformity in the terms of discretionary trust deeds (including as to how income is defined and the nature and extent of trustee powers in respect of characterisation and amounts that can be included in income of the trust). In our view, this makes it difficult (if not impossible) to adopt robust across-the-board solutions to trust issues in the short-term.

4. Given there is only approximately three months remaining in the 30 June 2011 income year, we believe it would be difficult (if not impossible) to educate those responsible for the 660,000 trust tax returns by 30 June on complex amendments to ensure that distributions reflected the amended law. In our view, any significant change to current practice would be impossible to implement and administer in the short-term.

[1] *Taxation Statistics* 2007-08, http://www.ato.gov.au/print.asp?doc=/content/00225078.htm

5. Our detailed submission highlights our concerns with the three options provided in the Discussion Paper for dealing with income of the trust. While the Assistant Treasurer has stated that a short-term solution would still have some problems, we believe the problems identified in this submission are too significant to ignore. In our view, not only do the options fail to resolve all of the issues with the current operation of the law, in some cases they create other issues. We do not see the merit in replacing one set of issues and unfair outcomes with another.

6. Dealing with all of the issues associated with the income of a trust is one which we consider would more appropriately be dealt with as part of the broader review of the trust provisions. Indeed, it is arguable that the proposals to require trustees to distribute amounts to avoid adverse tax outcomes when they would not otherwise be required to do so as a way of reducing inequities represents a policy shift deserving of more rigorous debate.

7. We believe that it would be possible to deal with a number of problems in the short term by codifying the past administrative practice of the ATO and rectifying the law where necessary to reflect the policy intent. Withdrawn Practice Statement PSLA 2005/1 and TR 92/13 have appropriately allowed for the streaming of capital gains and dividends on a quantum basis for 23 years[2] and 19 years respectively. To date, we are unaware of any issues the ATO has encountered with administering the taxation of trusts in accordance with these documents. Indeed, given the proximity to year end, it is unfortunate that the Commissioner is unable to administer the law in relation to capital gains and dividends in accordance with those documents to 30 June 2011.

8. This alternative option would not require a change to the meaning of income of the trust, but would instead make an adjustment to the share included in a capital beneficiary's income under Subdivision 115-C. This provision could be based on the PSLA 2005/1 as well as the dividend streaming provision currently contained in section 207-35. In essence, this alternative would be similar to Option 3 of the Discussion Paper, but would be contained outside Division 6 and would not apply on a mandatory basis.

9. A significant advantage of the alternative we propose is that PS LA 2005/1 in particular is familiar to trustees and/or their tax advisers and its codification would cause the least disruption of all the options outlined in the Discussion Paper. Furthermore, given that the amendment would be based on options that have worked in practice, we believe that this option can work as a short term solution.

10. We acknowledge that this alternative, like proposed Option 3, would not address unfair outcomes that might arise for reasons other than capital gains or opportunities for avoidance which are outside the scope of the general anti-avoidance rules contained in Part IVA of the ITAA 1936.

11. The Joint Accounting Bodies do not condone tax avoidance. However, we have reservations with the introduction of a specific anti-avoidance provision within Division 6 of the ITAA 1936 in conjunction with any short term option which does not provide a systemic solution to avoidance opportunities. We believe that Part IVA would be effective as an anti-avoidance provision in attacking blatant tax avoidance cases in the short term. In our view, a broad based integrity provision within Division 6 has the potential to result in significant uncertainty and compliance costs, particularly for the forthcoming 30 June year end. So, unless Treasury can develop an appropriately targeted provision, we ask that it carefully weigh the need or perceived need for such a provision in the short term against the added uncertainty and compliance costs such a provision may cause.

12. In relation to the treatment of dividends, we support the amendments that will provide certainty on the operation of the provisions and the removal of any double taxation related issues. In addition, we highlight that many issues associated with the distribution and streaming of

[2] Taking into the practice of the ATO since 1998, refer to PSLA 2005/1 para 28.

dividends seem to be due to the fact that a "notional franking credit" is required to be included in the net income of the trust. We believe that Treasury should also explore the possibility of removing the "gross-up" component of a franked distribution when determining the net income of a trust[3].

13. We also highlight that a number of issues could be overcome if the relevant CGT discounts[4] were not applied at the trustee level. Section 115-225 effectively requires this if the trustee accumulates the capital gain. An amendment to this effect would mean that a gross capital gain (after applying capital losses) would, instead, be included in the calculation of the net income of the relevant trust. We understand that there may be administrative issues for both the ATO and practitioners with this option (e.g. relating to the completion of tax returns and matching of data), but highlight this option for consideration nonetheless.

14. The focus of our submission is the discretionary trust segment of the market place and not MITs. However, given that there is a current review of the taxation arrangements relating to Managed Investment Trusts (MITs), we believe that it would be counter-productive if MITs were mandatorily required to apply the proposed amendments. Accordingly, we would recommend that Treasury consider allowing MITs to apply the amendments on an elective basis. Furthermore, where trusts are fixed trusts as that term is commonly understood, we believe that it is critical that they also be given the option of applying any amendments on an elective basis.

15. While we support the elective date of effect being 1 July 2010, we highlight that it may not be appropriate to apply these measures to taxpayers with a substituted accounting period (for example a 31 December 2010 early balancer). We would further recommend an "elective" start date for any entities where their 30 June 2011 income year commenced before 1 July 2010.

If you would like us to expand on any of the comments made in our submission, please contact Yasser El-Ansary on 02 9290 5623 or Susan Cantamessa on 02 9290 5625.

Yours sincerely

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[3] This would also exclude grossed up amounts that flowed indirectly through other trusts or partnerships

[4] That is, the 50% 12 month discount and the small business discount covered by subsection 115-215(3))

Submission
Improving the taxation of trust income

1. Overview

This submission highlights a number of our reservations in relation to the options canvassed in the Discussion Paper. Due to the limited period of consultation, we do not believe it is possible for us to identify all problems and issues associated with those proposals.

Accordingly, our submission is limited to outlining issues and significant uncertainties that we have identified under the proposed options.

2. Compliance concerns for closely held groups and trusts

The following table replicates statistics provided by the ATO for the 2007/08 income year in respect of the number of trust tax returns lodged for that year[5].

TABLE 6.1: Trusts, by type, 2007–08 income year		
Type	**No.**	**%**
Discretionary trust – main source from investment	261,188	39.6
Discretionary trust – main source from trading	205,780	31.2
Unit trust	76,909	11.6
Deceased estate	43,861	6.6
Discretionary trust – main source from service-management	38,015	5.8
Other fixed trust	18,488	2.8
Hybrid trust	8,867	1.3
Public unit trust – unlisted	4,766	0.7
Other	1,415	0.2
Cash management unit trust	581	0.1
Public unit trust – listed	454	0.1
Total	**660,324**	**100.0**

The statistics show that there was a total of approximately 660,000 trust tax returns lodged for 2007-08, with the majority of those returns being in relation to discretionary type trusts. As the Commissioner has previously indicated, there is insufficient uniformity in the terms of discretionary trusts deeds (including as to how income is defined and the nature and extent of trustee powers in respect of characterisation and amounts that can be included in income of the trust) to be able to adopt across the board solutions to trust issues[6].

[5] *Taxation Statistics* 2007-08, http://www.ato.gov.au/print.asp?doc=/content/00225078.htm

[6] For example, refer to the Commissioner's comments on trust deed's in relation to the issue of trust cloning in NTLG meeting 3 September 2008.

We believe any definition of “income of the trust estate” that is statutorily mandated to apply for tax purposes to all of these 660,000 trusts will require each of them to consider the implications of the change for the forthcoming 30 June 2011 distributions.

On this point, we note that we are already well into March, with approximately three months remaining for trust distribution resolutions to be made. We believe that any significant change in the way in which the system taxes trust income is likely to result in non-compliance by practitioners for 30 June 2011 trust distributions, due simply to the vast number of trusts that must comply with the amended law and the short time frame in which to do so. Any amendments that go beyond clarifying the way the law is believed to operate would likely result in significant uncertainty. Accordingly, it is unlikely that such changes would achieve the objectives of the review in the short term.

Accordingly, given that we are well into March 2011, that limited consultation has occurred on these proposals, that trust issues are very complex, and that differences between trusts are significant and unknown, we cannot support the proposal to mandatorily change the definition of income of the trust as a temporary resolution to certain trust issues. Accordingly, we can only support appropriate changes to the meaning of income of the trust if they are applied on an elective basis.

As outlined in the following sections, we have significant concerns with the three options in the Discussion Paper in Chapter 2. We also note that these issues have been identified in the short time frame that we have had to review the Discussion Paper, and accordingly cannot be a complete list of the concerns that could arise with implementing these options.

3. Option 1 (Defining distributable income as adjusted net income)

Option 1 canvassed in the Discussion Paper seeks to define the “income of the trust estate” as section 95 net income (**taxable income**), adjusted by relevant amounts (**tax distributable income**). This definition would override the definition of income contained in the trust deed (**deed distributable income**) for the purpose of applying section 97 and other assessing sections in Division 6.

We have a number of concerns with this approach, in particular, whether it provides appropriate outcomes in numerous circumstances. These concerns are summarised below.

Inequitable outcomes if deed distributable income cannot equate to tax distributable income

Option 1 is unlikely to provide an equitable outcome where the trust deed is incapable of equating deed distributable income to the tax distributable income of a trust. This is likely to be the case irrespective of whether the trust deed has discretions in relation to the character of income or expenses of the trust.

For example, a simple timing difference would result in the trustee paying tax under Option 1 at 46.5%. To demonstrate, consider a trust which does not define income and that derives ordinary income in year 1 of $400 when, because of a timing difference of $300, taxable income is only $100. The timing difference reverses in year 2 so that ordinary income is $100 and taxable income is $400.

In this very simple example, under the deed, the trustee will only be able to create a present entitlement to deed distributable income of $100 in year 2. So, beneficiaries will only be presently entitled to $100 of the $400 of tax distributable income, i.e. 25%, and hence required to include in assessable income 25% of taxable income of $400. This will mean that there would be no one presently entitled to 75% of the taxable income of the trust in year 2, resulting in a section 99A assessment. So, the trustee would be required to pay tax on 75% of the taxable income of the trust, at a rate of 46.5%.

So, instead of the beneficiaries being taxed on $100 in year 1 and $400 in year 2 (as a result of being presently entitled to all of deed distributable income of $400 in year 1 and $100 in year 2), beneficiaries are taxed on $100 in each year and the trustee taxed on $300 in year 2, despite having distributed this amount.

Absent an adjustment to tax distributable income, it would seem that the only way of avoiding this issue would be to accumulate $300 in year 1 and distribute that amount as capital in year 2. However, this would not be possible if the reversal of the timing difference occurs in the 30 June 2011 income year (i.e. as the $300 would have been distributed as income of the trust in the first year being 30 June 2010).

We highlight that this type of deed is common and that timing differences are also common. There are literally hundreds of possible timing differences that would give rise to this issue. They can be created by any difference in the time at which income or expenditure is recognised for the purpose of calculating taxable income and deed distributable income. They include differences in the timing of derivation of income (e.g. interest income on a receipts versus an accruals basis), any difference caused by the statutory timing of the derivation of income (e.g. dividends under section 44 or accrued interest income under Division 230), any difference in the timing of expense and deductions (e.g. provision for leave or depreciation), or any timing difference that subsequently results in adjustments to capital gains (e.g. Division 43 deductions).

In our view, it would be inequitable for the trustee to be assessed on any component of taxable income simply due to the effects of a timing difference.

Amendments to taxable income

Under Option 1, an adjustment to taxable income (either due to an error or an ATO amendment) would likely result in a section 99A assessment if the deed does not define income to be section 95 net income / taxable income.

For example, assume that a trust derives $100 of interest income, where the taxable income was also $100 for that year. Beneficiary A is made presently entitled to 100% of the income under the trust deed. Further assume that there is a subsequent adjustment by the ATO to include $50 of other income in the taxable income of the trust.

In this example, the tax distributable income of the trust would be adjusted to $150. Beneficiary A would only be entitled to $100, and accordingly there would be a section 99A assessment in respect of $50 (or 1/3 of the amended taxable income of the trust). There would seem to be no mechanism that would allow for an alternative result in this case.

We believe that this scenario would not be uncommon, and that this anomalous result is not consistent with the objective of the review.

In our view, this outcome is entirely inappropriate where the trustee makes a resolution to distribute 100% of the deed distributable/taxable income to the beneficiary. The section 99A assessment will only come about due to the proposed definition of tax distributable income.

Concept of notional amounts generally

Franking credits are only one of what are loosely described as notional amounts which certain trust deeds purport to include in the deed distributable income of a trust.

In our view, what constitutes a notional amount and whether tax distributable income should be adjusted to exclude these amounts is complex and should be subject to significant debate before any codification is possible.

For example, the inclusion of any amount in the assessable income of a trust as a result of a "deeming" provision is often cited as representing a notional amount. However, arguably many of those provisions operate when an underlying transaction occurs. For example, a deemed dividend may arise under Division 7A as a result of a loan made to a trustee shareholder. This tax treatment is notional when compared to the treatment of the amount as a loan for trust law purposes. However, as there is underlying cash (or a transaction) that may relate to the deemed dividend, the tax treatment may also be considered one of timing.

Furthermore, the Discussion Paper at page 10 canvasses whether certain expense items should also be excluded as notional items, such as Division 41 deductions. In our view, expenses do not create the same types of issues as compared to notional amounts of income. Furthermore, excluding notional expenses will require trustees to make capital distributions in order to create a present entitlement at 30 June. Many of these items will be unascertainable at 30 June, making it difficult, if not impossible, to ensure that the appropriate amounts flow through the trust, thus avoiding a section 99A assessment to the trustee at 46.5%.

For example, assume a trust with a tax equalisation clause earns $100 of income and has a tax deduction of $50 that is considered "notional". Assume the trustee resolves to distribute 100% of the income of the trust to Beneficiary A. In this example, unless a distribution of $50 of capital is also made, the trustee would be taxed on 50% of the taxable income of the trust. In our view, this is an anomalous outcome. Furthermore, whether a trustee will understand that a specific capital distribution of $50 needs to be made to the beneficiaries in order to avoid a section 99A assessment is questionable.

Finally, whether (in all cases) the trust deed will allow the capital to be distributed as at 30 June is also questionable. This is explored further in the following section.

Ability to distribute the capital amounts under a deemed income rule

Whether a trustee can include notional amounts in deed distributable income and make beneficiaries presently entitled to such amounts may depend on the relevant trust deed and the trustee's fiduciary obligations.

To demonstrate this issue, consider four different trust deeds which define income as follows:

- ordinary income with no discretions;
- ordinary income with a capital re-characterisation clause;
- section 95 income with no discretions; and
- section 95 income with a re-characterisation clause.

Assume that a trust enters into a contract to sell a CGT asset on 25 June, which has a deferred settlement of 12 months. Further assume that the capital gain qualifies for the 50% CGT discount for tax purposes. Based on ordinary concepts, the capital gain is derived at the time of settlement (refer to *Gasparin's* case). For tax purposes, the capital gain is derived at the time of entering into the contract.

Under the first deed, the capital gain would be capital of the trust. The deed may not allow the trustee to confer entitlement to the capital on any beneficiary until the time of settlement. Under the second deed, the re-characterisation clause may allow the trustee to treat the capital gain as income (as per *Bamford's* case), which may allow the trustee to create a present entitlement to the amount at 30 June under the deed. The third deed would treat 50% of the capital gain as income and 50% as capital (giving rise to a hybrid of the two previous trust deeds). The last deed would treat 50% as income and 50% as capital, with a discretion to treat the capital component as income such that a present entitlement could be created at 30 June to the whole capital amount.

The example demonstrates that, under the first deed, it may not be possible to create an "entitlement" to the capital until well after year end. As a result, the proposed definition of trust distributable income for the purpose of section 97 would likely give rise to a section 99A assessment. Furthermore, if the trust were to stream the capital gain to the beneficiaries, problems may occur under the first and third deed, if the deed does not allow the trustee to create an entitlement to the whole capital amount until after year end (this second issue is discussed in further detail in the next section).

The issues identified above have arguably been avoided in Practice Statement PSLA 2005/1, where at paragraph 14, the document states:

> *"A capital beneficiary can only make such an agreement to the extent that they have a vested and indefeasible interest in the trust capital representing the capital gain at the end of the income year or have been allocated the capital gain."*

That is, the practice statement did not attempt to modify what was "income of the trust", but provided a different allocation system (being similar to the mechanism used in section 207-35).
While the term "allocated" is not defined in the practice statement, paragraph 9 states that it is taken to "include" crediting or distribution to a beneficiary, its payment or application on behalf of, or for the benefit of, a beneficiary or, in the case of a deemed capital gain, its allocation notionally by the trustee.

In the example provided earlier, we believe that this practical approach would have allowed the allocation of the capital gain to a capital beneficiary in an appropriate manner under all four trust deeds (even if the deed would not allow a capital distribution for 12 months after year end). That is, provided the trustee was committed to appointing the amount to the beneficiary (either now or in the future) and that the beneficiaries had signed a relevant agreement evidencing this arrangement, we understood that this was sufficient to satisfy the "present entitlement" requirement for capital beneficiaries under any of the deeds outlined above.

Interaction with the streaming provisions and certainty on distributions

We are not sure how Option 1 will interact with the proposed capital gains streaming provisions. That is, absent any adjustment, while tax distributable income would only include the net capital gains, section 3.2.1 of the Discussion Paper will require a separate capital distribution to be made to a beneficiary, equal to the discount amount.

As outlined in the previous section, this may create difficulties where, based on ordinary concepts, a capital gain is not recognised until after year end. Furthermore, if the deed defines income as section 95 income, the breakdown between income and capital under a trust deed will require the trustee to determine before 30 June whether the discounts will apply to the capital gain. However, at 30 June it may be uncertain whether certain capital gain discounts will be available (e.g. whether the trust will satisfy the small business 50% concession). A trustee may not be able to determine whether an amount is technically deemed to be income or capital at 30 June under the trust deed in order to prepare resolutions which appropriately reflect the proposed definition of income of the trust.

Where a deed defines income of the trust to be section 95 income, a resolution stating that a beneficiary is entitled to 100% of the net capital gain at 30 June may only result in a present entitlement to 25% of the capital gain (where the 50% CGT discount and the 50% small business reduction are both available). For example, assume that a trust:

- has interest income of $50 and a gross capital gain of $1000;
- the 50% CGT discount and the 50% small business reduction are available and that entitlement to the concessions is only determined by the trustee after 30 June; and
- the trust deed defines income as section 95 income / taxable income.

In this example, the income of the trust will be $300 (i.e. the $50 interest plus the $250 capital gain) and the capital of the trust will be $750. In order to effectively stream the capital gain, the trustee will be required to make a resolution to distribute $250 of income to the beneficiary and $750 of capital to the beneficiary. If both these resolutions are required by 30 June, this will create an administratively difficult situation for the trustee, who may not be able to create such an entitlement at that date (for reasons outlined earlier).

This administrative issue did not occur under PSLA 2005/1. This is because paragraph 8 states that:

> *"The Commissioner will accept … treating a beneficiary as having a capital gain or gains for the purposes of subsection 115-215(3) of the ITAA 1997 to the extent that the beneficiary … has … been allocated the trust's capital gain no later than two months after the end of the income year. In determining whether the trust capital gain <u>has been allocated</u>, the Commissioner will rely on the way the <u>trustee characterises it</u>."*

Applying PSLA 2005/1 to the example, the trustee would have two months to determine to distribute or allocate the whole capital gain (gross) to the beneficiary. Accordingly, if a resolution at 30 June determined to distribute 100% of the net income representing the capital gain to the beneficiary (i.e. $250), the streaming would be effective if the trustee also *allocated* 100% of the discount component to the beneficiary within two months of year end.

In our view, a real disconnection between Option 1 and the streaming provisions will occur where a component of a capital gain is treated as capital under the deed but is included in tax distributable income. Resolution of this issue may result in new rules that trustees need comply with, resulting in further uncertainty for 30 June distributions. We have highlighted an alternative option for dealing with this issue in Section 6 below.

Retrospective uncertainty where notional amounts included in deed distributable income

Treasury's Discussion Paper could be read as signalling that there are retrospective problems with prior year assessments of trustees/beneficiaries where notional amounts have been included in deed distributable income. In particular, the example contained in the Discussion Paper on page 11 seems to suggest that a section 99A assessment may arise under the current law if amendments are not made.

Our detailed comments on this issue are contained in Section 8 of this submission. We recommend that Treasury clarify their position on this issue with the ATO.

4. Option 2 (Defining distributable income based on accounting concepts)

Option 2 outlined in the Discussion Paper considers whether tax distributable income can be defined with reference to accounting concepts, i.e. accounts prepared in accordance with generally accepted accounting principles (GAAPs) determined under Australian Accounting Standards.

We understand that this option would mean that a trust would be required to apply the accounting standards applicable to the trust. Accordingly, if the trust were not a reporting entity, it would not be required to strictly apply AIFRS, but instead would be allowed to apply accepted accounting principles having regard to the nature of the trust's activities.

In theory this proposition has significant merit, as it would allow a trust to be able to distribute its profit to beneficiaries (being generally the amount of the economic benefit to be provided to the beneficiaries). However, as many deeds may not define income to be "accounting profit", this may also result in amounts that beneficiaries cannot be made presently entitled to under the deed.

Furthermore, if GAAP were defined to equal an amount determined under the Australian Accounting Standards (requiring a compulsory application of all of the accounting standards), taxpayers in the middle market would be unable to comply with this requirement. In addition, the accounting standards would create a significant number of income or expense items that would be (effectively) notional accounting amounts. These items may also have no basis in the trust deed. This may give rise to amounts that no beneficiary can be presently entitled to. The consequence of this would likely result in section 99A assessments to the trustee at 46.5%.

Accordingly, while this option may be considered in a broader review of trusts, we do not believe this option could be practically applied by the vast majority of trusts for the 30 June 2011 income year as a short term solution.

5. Option 3 (Defining distributable income to specifically include capital gains)

The third option canvassed in the paper would only affect trusts whose deed did not include gross or net capital gains in deed distributable income. In these cases, trustees would be required to determine tax distributable income, being deed distributable income plus [gross or net] capital gains. To avoid the trustee being taxed under section 99A, it would be necessary for beneficiaries to be presently entitled at year end to all of the deed distributable income in the usual way and also for beneficiaries to be "presently entitled" to capital gains by year end. Only in this way could it be said that beneficiaries are presently entitled to all of the tax distributable income of the trust and hence subject to tax on all of the taxable income of the trust.

We highlight that this option creates many of the same issues identified in relation to Option 1 where tax distributable income is different to deed distributable income. That is, many of the same issues will occur if the deed defines income based on ordinary concepts. These problems would not be limited to those types of deeds. Similar problems would also occur if the tax distributable income included a gross capital gain, while the deed defined income as section 95 income (i.e. which would include the discounted capital gain in deed distributable income).

However, in addition to the issues raised in respect of Option 1, Option 3 gives rise to two further issues for consideration. The first is the proposed mandatory application of the Option. The second is the proposed integrity provision.

Mandatory treatment of capital gains

We highlight that Practice Statement PS LA 2005/1 was not mandatory. It only applied if taxpayers entered into an agreement to shift the burden of tax on a capital gain.

Given that approximately nine months of the 2011 income year have already elapsed, we do not support mandatory application of new rules that would deem capital to be tax distributable income of a trust. We believe that it is critical for trustees and beneficiaries to be able to have a choice in respect of the proposed treatment.

For example, capital gains may have already been derived by a trustee and the capital proceeds invested in a new (non-liquid) asset. If the trust deed defines income as ordinary income, reinvesting the funds would not have been a concern based on the law at the time of these events. To now require a capital distribution by 30 June 2011 to avoid a trustee assessment would be both inequitable and unjust. In effect, to avoid being assessed a trustee may need to either dispose of the asset before 30 June to fund the distribution or borrow to pay the distribution. Disposing of the asset will have tax consequences. Borrowing to fund the distribution will also give rise to further issues, including the deductibility of interest under TR 2005/12. There may be other issues we have not identified.

Furthermore, in many cases, a trustee will not want to stream capital gains to different beneficiaries. Accordingly, in those cases, it is not important to have a capital gain being defined as income of the trust to ensure that an appropriate tax treatment occurs under the current law.

Proposed integrity provisions

The Joint Accounting Bodies do not condone tax avoidance. However, we are concerned that a hastily drafted integrity provision to first apply to 30 June 2011 distributions may cast a net broader than is necessary to attack the sort of practices which have been identified as being of concern. For example, a discretion to stream income, even for the purposes of the proposed capital gains or dividend provisions, would likely result in a requirement to consider the proposed integrity provision (as a discretion has been applied that has a certain tax outcome). Furthermore, a timing difference may give rise to a significant “economic” difference that may breach any integrity provision proposed. We see potentially significant compliance and administrative issues from a broad based integrity provision, particularly for 30 June 2011 distributions.

In our view, blatant manipulation of taxable income, such as that covered by example two of the Discussion Paper, would be caught under Part IVA. We are sympathetic to the fact that there may be less blatant schemes where pursuing the application of Part IVA may be problematic. However, unless a targeted provision can be developed that does not need to be considered in the vast majority of cases where no mischief is involved, we ask that Treasury carefully condier the need or perceived need for a specific provision at this time. The broader review of the trust provisions should provide an opportunity to consider avoidance issues in a systemic way.

6. An alternative option – codifying PS LA 2005/1

The issues addressed in the Discussion Paper are not new issues. Furthermore, many of these issues have been administered by the ATO practically for a significant number of years. In particular, we note that the ATO has accepted the streaming of dividends under a quantum approach for approximately 19 years through TR 92/13. Furthermore capital gains have also been streamed under a quantum approach for seven years through Practice Statement PSLA 2005/1 and previously through its predecessor, PSLA 2004/3. Practice Statement PSLA 2005/1 itself notes that the practice of streaming capital gains has been in place since 1998. Paragraph 28 the PSLA states the following:

> *28. The policy of the CGT provisions is to assess the beneficiary who is 'presently entitled' to the capital gain (see the Explanatory Memorandum to the Bill which became the Income Tax Assessment Amendment (Capital Gains) Act 1986). Also, at the meeting of the Capital Gains Tax Subcommittee of the Tax Liaison Group on 22 September 1988, Second Commissioner Brian Nolan stated that 'it is the ATO practice to assess any [excess of] net income over trust accounting income because of a capital gain to the capital beneficiary'. This Tax Office practice is also reflected in paragraph 4 of Taxation Determination TD 93/35.*

These documents provide guidance as to how amounts can be streamed under our current law, in what circumstances and on what conditions. These practices have been administered by the ATO for more than 20 years.

The simple approach taken in the practice statement is not to disturb what is "income of the trust", but instead to adjust what is the share of net income of the relevant beneficiaries after the application of section 97. The approach is similar to the way in which franking credits are streamed under section 207-35.

For example, assume a trust has derived a capital gain of $100 and other income of $10. Assume the deed has an ordinary income clause. If all of the income of the trust is distributed to Beneficiary A (i.e. $10), section 97 would apply ordinarily to include $110 of net income in the assessable income of Beneficiary A. The practice statement operates after this fact by excluding $100 from the assessable income of Beneficiary A and would include the $100 in the income of the capital beneficiary, provided the capital beneficiary has been allocated the capital gain. This is similar to the process currently contained in section 207-35. We believe that this approach could also be taken in section 115-215.

However, as outlined earlier, at this late stage in the consultative process it is critical that the proposed amendment be optional (akin to the practice statement). However, where this option is chosen, we believe that the capital beneficiary would need to be allocated the "gross gain" and not the net capital gain in order for the provision to work appropriately.

As this approach would require the trustee to consider capital distribution clauses of the trust deed, it is important that a strict distribution / present entitlement rule is not used and that a broader "allocation" type rule be considered by Treasury.

Given the precedent contained in PSLA 2005/1 and section 207-35, we believe that this practice could more readily be codified in the short-term. Given that this is the long standing practice of the ATO, most taxpayers would be familiar with this practice. Accordingly, we would strongly recommend that both Treasury and ATO consider this alternative option for dealing with these issues in the short term.

7. Removing certain notional amounts at the trustee level

In implementing the alternative option, we highlight that the "streaming" solutions will require modifications to be made to the capital gains provisions (Subdivision 115-C) and the franking provisions (Subdivision 207-B).

Where this is the case, we believe there is some merit in Treasury considering whether the notional tax adjustments contained in those Subdivisions should be removed from the calculation of net income of the trust estate. For example, if a trust derived a dividend of $70 and a discount capital gain of $100, it would ordinarily have taxable income of $150. Removing the notional adjustments from those Divisions would mean that the section 95 income would be $170 instead. This would equate to the economic gain derived by the trust. The notional adjustments (i.e. the franking credit gross up and the CGT discounts) would be applied at a beneficiary level.

We understand that this approach could have a number of consequential amendments throughout the tax legislation, and may also give rise to administrative issues in the preparation of tax returns as it is too late to change 2011 tax return forms. However, if these issues can be dealt with, this option may help to better align distributable income with economic gains made by the trust.

8. Dealing with distributable income

Option 1 envisages adjustments being made to the taxable income of a trust to determine deed distributable income in order to avoid inequitable outcomes which arise under the current law. To illustrate this point the Discussion Paper, on page 11, gives an example illustrating that, where a deed has a tax equalisation clause, franking credits would be included in deed distributable income but, because they represent a notional amount, no beneficiary could be made presently entitled to these amounts.

So, when determining a beneficiary's share of the income of the trust estate, franking credits are excluded from the numerator but included in the denominator. In these circumstances beneficiaries will always be presently entitled to less than 100 percent of deed distributable income with the result that the trustee will be taxed on a portion of the taxable income of the trust under section 99A. To avoid this outcome, in determining tax distributable income, the Discussion Paper suggests adjusting the taxable income of the trust to exclude franking credits.

If this is indeed the way in which the current law operates, or there is an argument that the law operates in this way, then simply addressing this issue for the 2011 and subsequent years will leave taxpayers exposed or potentially exposed in respect of earlier years.

If it is believed that a section 99A assessment could or would arise under the current law when a deed purports to include franking credits in deed distributable income, we believe it is imperative for this issue to be addressed either by Treasury or the ATO in respect of both prior and future years.

For example, if the trust derives $70 of dividend income, with a $30 gross up for franking credits, it seems that there is now some uncertainty as to whether it is possible to make beneficiaries entitled to anything more than 70% of the income of the trust (where the deed income is defined as section 95 income). This is because the income of the trust is arguably $100, while the present entitlement is to $70 only of income.

If the ATO believe that the income of the trust is only $70, then no issue would occur. We ask that Treasury work with the ATO to resolve whether an issue exists under the current law. To the extent that a section 99A issue does not exist, we would recommend that the ATO provide its view in a taxation ruling as soon as possible before 30 June (irrespective of which option is chosen by Treasury). This will clarify this issue well before year end.

To the extent that a section 99A issue does exist, we believe that a (taxpayer optional) retrospective amendment could be inserted in Division 6 that effectively achieves the following:

> *In calculating a beneficiary's share of the net income of the trust estate for the purpose of this Division, reduce the amount that would otherwise be the income of the trust estate by any amount where no beneficiary could have a vested and indefeasible interest in that income amount as against a trustee.*

Not only could this possible amendment address the section 99A assessment problem for the 30 June 2011 year, but could also help to ensure that the identified issue does not result in a section 99A assessment for prior years. We believe it is critical for Treasury to consider this issue due to the uncertainty created through the Discussion Paper example on page 11.

9. Application to MITs and fixed trusts

Given the current review being undertaken for MITs, to provide an "attribution" model for calculating the allocation of the net income to beneficiaries, we believe it would be counter-productive to mandate any of the proposed changes to MITs. The short term fix may have significant implications for reporting and recording trust distribution amounts and for dealing with the income of the trust. We would recommend that Treasury consider allowing MITs to adopt the amendments on an optional basis.

There are a number of other trusts that are "MIT like" trusts, which may not technically be MITs under Division 275. Most of these trusts are generally considered fixed trusts. In these cases, the amendments proposed in the discussion paper may generally not be required where the beneficiaries have a vested and indefeasible interest in the income and capital of the trust, irrespective of the distributions of the trustee. As the proposed amendments could give rise to a number of practical and trust issues, we believe it is appropriate to ensure that fixed trusts also have an opportunity to apply the amendments on an elective basis.

10. Application date

As highlighted throughout this submission, we have significant reservations with a mandatory change to the income of the trust or any amendments to deal with capital gains in cases where there is no streaming. In such cases, we can only support an elective provision that deals with the capital gains as an interim solution.

We would also generally support an elective application date of 1 July 2010, but for those cases where the relevant entity has a substituted accounting period (SAP) in lieu of the 30 June 2011 income year and the taxpayer is an early balancer (e.g. a 31 December 2010 balancer). In that case, it may not be appropriate to mandate the proposed changes. Accordingly, in these cases, we would recommend that SAP taxpayers be given a choice as to whether to apply any proposed changes for their 30 June 2011 income year.