Law Council
OF AUSTRALIA

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Dear Mr Bradshaw

Improving the taxation of trust income

The Taxation Committee of the Business Law Section of the Law Council of Australia ('Committee') welcomes the opportunity to participate in these Treasury consultations to improve the taxation of trust income. The Committee understands that as an interim step the Government has decided to amend the law to:

- better align the key concept of 'income of the trust estate' (which has been interpreted to mean distributable income) with the tax law concept of 'net income of the trust estate' (taxable income), so as to reduce anomalous outcomes and opportunities to manipulate tax liabilities; and
- ensure that capital gains and franked distributions (including the attached franking credits) can be streamed to particular beneficiaries.

The Committee sets out below its observations and submissions on the merits of the different approaches that could be adopted to amend the current tax law to achieve these outcomes. The Committee also understands that the Government is not suggesting that the reforms should require changes to the general law of trusts. Please note that the Business Law Section endorses the Committee's observations and submissions.

In summary the Committee considers that:

1. to ensure a better alignment of distributable income and taxable income, the interim measures should be available at the option of taxpayers. That is, trustees may elect that the newly defined distributable income applies in their circumstances;
2. as part of these interim measures the Government should confirm that no trust resettlement will arise where trust deeds are amended to align with the

proposed reforms and all endeavours should be made to encourage the State and Territory Governments to remove any stamp duty impediments to any necessary amendments to trust deeds;

3. either Option 1 or Option 3 should be adopted as an interim measure;

4. Option 2 should not be adopted as an interim measure;

5. none of the options deal with the difficulties encountered in establishing present entitlement;

6. the proportionate view should continue to apply to these interim measures;

7. a definite timetable of no more than 12 months should be announced to complete the review and taxation reforms for trusts so that these interim measures do not apply indefinitely;

8. the concept of a 'fixed trust' for the purposes of the Tax Act will need to be amended to allow franking credits to pass through a trust that is not a 'family trust';

9. the Government's proposal to amend the current tax laws to remove any possible uncertainty that might surround the ability to stream franked dividend distributions and net capital gains to particular beneficiaries of a trust is welcomed but this should also include flow-through for other types of income on the basis that that trust income retains its characterisation when distributed to a beneficiary.

The above points are explained below together with answers to the specific questions posed.

Detailed Submission

1. The Committee submits that the interim measures to ensure a better alignment of distributable income and taxable income should be available at the option of taxpayers. That is, trustees may elect that the newly defined distributable income applies in their circumstances.

1.1 The following brief explanations are provided in support of this submission:

(a) The Committee understands, and appreciates, the Government's desire to provide a prompt solution to increase certainty for taxpayers and tax advisers for the current income year. Unfortunately, the complexity of issues the arise in relation to the taxation of trusts, compounded by the vast array of types of trusts and the lack of uniformity of terms of trust deeds, even within the same type of trust, means that there can be no "quick fix" to this issue.

(b) In supporting an interim measure, the Committee understands that there will necessarily be deficiencies and limitations on the effectiveness and application of any interim measure proposed. However, the Committee

expects that the broader review of the taxation of trusts should be focused on achieving a more widely applicable solution for the future.

(c) As the interim measure in the form proposed (by amending the definition of distributable income, but without addressing underlying concepts of present entitlement, or reviewing the law of trusts and the interaction of trusts law and tax law) cannot provide a perfect solution for all trusts, it must not be a mandatory measure, but available by election of the trustee.

(d) This would allow the trustee to confirm that the interests of the beneficiaries of the trust will not be adversely affected where an election is made to allocate the taxable income based on present entitlements to the newly defined distributable income after considering the specific terms and arrangements applying to the trust.

(e) The Committee understands the proposed reforms will apply to all trusts. Different issues and considerations will have more, or less, relevance for different kinds of trusts. Division 6 currently applies to all trust arrangements, which encompasses a wide variety of different forms of trusts. These include: family or private discretionary/unitised/hybrid trusts; collective investment vehicles or public trusts (registered and unregistered managed investment schemes - retail and wholesale); listed trusts; custodian arrangements; bare trusts; investor directed portfolio services; and foreign trusts that have Australian income or investments. In the short time provided for consultation, the Committee has not fully considered the implications for all these different trust arrangements but it considers that it is unlikely that one approach will suit all forms of trusts.

(f) Trusts that are collective investment vehicles may need to be treated separately. The Committee considers the consultation time provided is too short to allow retail and wholesale collective investment vehicles to consider and implement information systems upgrades or trust deed changes and/or prepare relevant investor notifications for such changes (where required).

(g) The Committee considers the time allowed is too short to allow other trustee taxpayers to amend trust deeds (assuming the deed provides power to do so) to ensure the entitlements created under the terms of the trust deed will not result in the trustee paying tax under section 99A (at the top marginal tax rate). This would be an unfair outcome

(h) The Committee considers the time allowed is too short to enable a thorough or appropriate review of even the interim proposals and consequential impacts of those changes.

2. The Committee submits that as part of these interim measures the Government should confirm that no trust resettlement will arise where trust deeds are amended to align with the proposed reforms.

2.1 That is, where trust deeds are amended to align with the definition of trust income with the newly defined distributable income to be inserted for the purposes of applying Division 6 of the Tax Act or where trust deeds are amended to identify classes of income which include capital gains and dividends.

2.2 The following brief explanations are provided in support of this submission:

(a) trust deeds may need to be amended to ensure no adverse consequences arise for beneficiaries from the proposed amendments. For example, in the case of the “Option 1” alignment proposal, a trust deed which did not allow distributions of capital prior to the trust vesting date may need to be amended to enable the trustee to do so (or face assessment under section 99A on the capital gain). Further, in the case of the example 7, the streaming of franked dividends is predicated on the deed allowing the trustee to do make the appropriate distributions.

(b) The current position regarding the circumstances in which a trust can be “resettled” for income tax purposes as a result of an amendment to the deed remains unclear because of a discrepancy between the Commissioner's stated position and recent case law. The Commissioner’s published “Statement of Principles” on this subject has not been updated to reflect more recent decisions. There are divergent views about the views expressed in those Statement of Principles and in any case it is difficult to provide a ‘clean’ or unqualified opinion given the views expressed by the Commissioner. This ‘uncertain’ state of affairs should be clarified by amendment of the Commissioner's Statement of Principles, and legislative amendment associated with changes to Division 6, where trust deed changes may need to be implemented in a short period of time.

(c) While it is possible that further clarity will be obtained if the High Court grants leave to the Commissioner to appeal the decision of the Full Federal Court in Commissioner of Taxation v Clark[1], that case did not concern any amendments to the trust deed, as the court pointed out. It is essential, in any event that provisions be introduced that specifically allow trust deeds to be amended to align with and take advantage of the proposed amendments, without triggering either CGT event A1 or CGT event E1.

(d) It may be the case that amendment of the terms of a trust deed, where that is possible, could be required to achieve any effective improvement of the taxation of trusts. This is likely to be the case whatever legislative approach is taken. Further, there will be cases where amendment of the trust deed is not able to occur, or cannot be easily achieved, due to the terms of the trust deed and/or the composition of beneficiaries. In seeking to address the taxation of trusts without impeding on trusts law, it will be impossible to achieve a uniform solution that will apply to all trusts. As part of the broader review of the taxation of trusts, careful

[1] [2011] FAFC 5

consultation with State and Territory Governments about the critical interaction between trusts law and tax law will be required to ensure a lasting and effective solution is achieved.

2.3 However, any requirement for amendment of trust deeds will need to be carefully considered, as State and Territory stamp duties will apply, subject to any unanimous agreement by State and Territory Governments to provide exemptions for, or waive, any stamp duties arising on a trust resettlement in this case. Any trust with real property assets would be impeded from making any required amendments because of the potential stamp duty impost, if cross-governmental relief is not provided.

3. We submit that either Option 1 or Option 3 should be adopted as an interim measure.

3.1 For the reasons noted above, the Committee considers that this should be at the election of the trustee taxpayer, with the default position (in the absence of any election being made by the trustee) to be that the existing law continues to apply in its current state.

3.2 The election to adopt Option 1 or Option 3 should be an interim measure to enable a broader and more thorough review of the taxation of trusts to occur. This may result in a more appropriate mechanism for determining trust income in line with other amendments that may be made, or to better integrate with other provisions of an amended taxing regime.

3.3 The following brief explanations are provided in support of this submission:

(a) The Committee's summary of the advantages and disadvantages arising in relation to each option is included at Annexure A, B and C, as follows:

Annexure	Option	How to align trust income and tax income?
A	1	define distributable income to equate with section 95 net income
B	2	require that the distributable income should be determined in accordance with generally accepted accounting principles
C	3	continue to allow the distributable income to be determined under the terms of trust deeds subject to a proviso that capital gains will be deemed to be included in distributable income irrespective of whether this would be the case under the trust deed provisions.

(b) The Committee submits that Option 1 provides the primary benefit of ensuring that the beneficiary will not be taxed on an amount that is greater than their share of distributable income.

(c) However, it is not clear under Option 1 if the beneficiary or the trustee will be assessed on any amendment to the taxable income amount and whether this approach involves a proportionate, quantum or hybrid allocation approach.

(d) Also, without any amendment to the concept of present entitlement, it is unclear how Option 1 might deal with differences between cashflow and tax amounts, such as non-deductible expenses which reduce the amount to which a beneficiary may be presently entitled under trust law concepts. The terms of a trust deed are critical to determine what powers the trustee might have in determining distributable amounts. These are not easily overcome by legislative amendment and are likely to require amendments of trust deeds (where possible) in many cases.

(e) The issues of the appropriate approach to allocations, for example in the case of an amended assessment, and the interaction of the terms of trust deeds, and differences between trust concepts of present entitlement and vested and indefeasible interests and the tax concepts proposed to be introduced would need to be carefully considered for an interim solution, and would also need to form part of the broader review of the taxation of trusts contemplated in the Discussion Paper.

(f) In considering Option 1, the Committee has assumed that:

(i) Where any excess of taxable income over distributable income reflects accretions to the trust estate (e.g. capital gains) the amount to be included in the assessable income of each beneficiary will reflect its entitlement to the amounts included in the net income of the trust estate.

(ii) Similarly amounts which are not accretions to the net income but which have concessional taxation advantages such as franking credits (as in *Thomas Nominees Pty Ltd v Thomas & Ors* [2]) will also be included in the assessable income of the beneficiaries.

(iii) Some consider that there is still some doubt as to whether beneficiaries can become presently entitled to amounts which do not reflect accretions to the trust estate (generally referred to as notional income)[3]. Others consider present entitlement can attach to such notional amounts. Such amounts include some amounts assessed under Part IVA (e.g. ***Grollo Nominees Pty Ltd v Federal Commissioner of Taxation***[4]) and increases in the capital proceeds (or decreases in the cost base) of a CGT asset under the market value substitution rules in Divisions 116 and 112 of the 1997 Act respectively. The Committee considers such notional amounts should fall within net income and the relevant beneficiaries should be able to be presently entitled to them.

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[2] [2010] QSC 417 (11 November 2010)

[3] The possible doubt arises from the Court's comments in relation to present entitlement at p.506

[4] (1997) 73 FCR 452

(g) The Committee submits that Option 3 provides the following benefits:

(i) As an interim measure it seems to involve the least impact on trust administration (one of the stated objectives) and appears to address the concerns raised by capital gains being excluded from trust income.

(ii) Many private trust deeds already give the trustee the discretion to determine what will be the distributable income of the trusts and/or will already include capital gains as part of that distributable income. Therefore, this minimalist approach will provide a safety net for other trusts and is expected to have the least impact on the SME sector where there are vast numbers of trusts that will be affected.

(h) Although, adverse outcomes may arise under Option 3 for capital beneficiaries of testamentary trusts, it otherwise provides an appropriate safety net. Such testamentary trusts could be carved out of the proposed treatment if necessary.

4. Details of a further alternative for your consideration.

4.1 Although the Committee considers this alternative may not be capable of being developed in time for an interim solution, the Committee provides this alternative to illustrate a different approach to the issues raised and potentially for further consultation as a possible longer term solution, as invited in paragraph 2.2 of the Discussion Paper.

4.2 Under this alternative, taxable income is attributed to the beneficiaries of the trust according to each beneficiary's proportionate entitlement (as determined under the trust deed) of realised increases in the trust fund (that is, realised increases in the trust property, both income and capital) during the financial year.

4.3 The key advantages of this approach are:

(a) that it is consistent with the "conduit" nature of a trust; and

(b) there would be no requirement to redefine 'income' and 'capital' of the trust. That is, since any increase to which a beneficiary is entitled will be relevant for the purposes of allocating the taxable income of the trust.

4.4 Further details of this alternative are included at Annexure D. The Committee would be pleased to discuss and develop this alternative further as part of the broader review of the taxation of trusts.

5. The Committee submits that Option 2 should not be adopted as an interim measure.

5.1 The following brief explanations are provided in support of this submission:

(a) A definition of distributable income based on accounting income will clearly not achieve the specified objective of better aligning a trust's distributable income with its taxable income.

(b) Many existing trust deeds include a definition of distributable income based on generally accepted accounting principles or provide power to the trustee to adopt a concept of distributable income based on generally accepted accounting principles.

(c) Trustees will be required to adopt accounting standards for the purposes of trust administration and changes in accounting standards will result in changes to distributable income for tax purposes.

(d) Accounting standards can result in counter intuitive and sometimes perverse concepts of income for example, where distributions to beneficiaries of fixed trusts are treated as expenses of the trust so that there is no amount of accounting income.

(e) The Committee considers that the discrepancy between 'accounting' concepts of income and taxable income have given rise to the complexities that (in part) this reform is trying to resolve.

(f) The distributable income amount will be aligned with accounting standards, such that unrealised gains and losses put through the income statement could materially impact what is required to be distributed to ensure no assessment falls on the trustee (in the case of a positive accounting result) or (in the case of a negative result) force the position that the assessment for the year's taxable income falls on the trustee.

6. The Committee submits that none of the Options deal with the difficulties encountered in establishing present entitlement

(a) The Committee considers the difficulties associated with the concept of present entitlement should be considered and resolved as part of the broader review of taxation of trust income.

(b) This is another reason why the current measures should only be made as interim measures, as the ultimate operation of Division 6 relies on the appropriate application of other concepts, including the concept of 'present entitlement', which are simply not addressed by the proposed interim measures.

(c) Many trust deeds would not contain distribution mechanisms that would permit adopting any of the options proposed as an interim measure. This creates a problem of potentially creating inequity between trusts and further difficulties in applying remaining concepts of present entitlement and terms of existing trust deeds with new statutory definitions.

7. The Committee submits that the proportionate view should continue to apply to these interim measures

(a) The merits and difficulties in applying each of the proportionate, quantum or hybrid views should be considered as part of the broader review of taxation of trust income.

8. The Committee submits that a definite timetable of no more than 12 months should be announced to complete the review and taxation reforms for trusts so that these interim measures do not apply indefinitely.

8.1 The following brief explanations are provided in support of this submission:

(a) The alternatives set out in the Discussion Paper are intended to resolve as an interim measure various uncertainties arising from the operation of Division 6.

(b) Without a detailed analysis and consultation process, the problems which exist cannot be remedied in the short term for the broader range of trusts and each of the alternatives will still result in a degree of uncertainty for trustees and beneficiaries. The Committee appreciates that reform to the system of taxing trusts and beneficiaries is urgent, but the certainty sought for the short term by the introduction of interim measures cannot be achieved by making any of the alternatives compulsory.

(c) The introduction of any interim measures attempting to align distributable income with taxable income other than on an optional basis will effectively result in taxpayers having to deal with a number of significantly different taxing regimes with the attendant costs and complications until the proposed rewrite is finalised.

(d) A preferable approach to resolving the perceived problems would be better facilitated by an early and detailed rewrite of Division 6 into the *Income Tax Assessment Act 1997* (Cth).

9. The Committee submits that the concept of a 'fixed trust' for the purposes of the Tax Act will need to be amended to allow franking credits to pass through a trust that is not a 'family trust'.

9.1 The following brief explanations are provided in support of this submission:

(a) The current rules broadly only allow franking credits to pass through a trust that is a fixed trust or a trust that has made a family trust election.

(b) Parliament could not have intended for a trust to *not* be a fixed trust merely because of a statutory regime (i.e. in the *Corporations Act 2001* (Cth)) which provides members of a managed investment scheme with a power to amend the relevant deed (refer *Colonial First State Investments Limited v Commissioner of Taxation* [2011] FCA 16).

(c) Where the only issue as to whether a particular trust is a 'fixed trust' relates to the statutory powers to amend the deed, then:

(i) the government should introduce legislation which provides that in such situation, a trust will be treated as a fixed trust for income tax purposes; or

(ii) failing that, the Commissioner should clearly announce that he will exercise his discretion under sub-section 272-5(3) of Schedule 2F to the *Income Tax Assessment Act 1936* (Cth).

(d) A full review of the concept of 'fixed trust' should be undertaken as part of the broader review of the taxation of trusts, with clearer provisions being enacted which do not rely on the exercise of the Commissioner's discretion in a greater range of standard commercial cases.

Enabling the streaming of franked distributions and net capital gains

10. The Committee welcomes the Government's proposal to amend the current tax laws to remove any possible uncertainty that might surround the ability to stream franked dividend distributions and net capital gains to particular beneficiaries of a trust.

(a) The attribution of the character of income through a trust structure should be an undeniable trait of taxation of a trust. Nothing in underlying trust law would support the characteristics of income being distorted between the receipt of income to the trust and distribution of that income to beneficiaries.

(b) Where current legislation supports the retention of character of particular income (especially franked dividends and franking credits) through a trust structure, it is disappointing that any ambiguity has arisen as a result of ATO practice or administration. Confusion relating to the ability to directly stream franked dividend income (and attaching franking credits) through a trust was recently demonstrated in the case of *Thomas Nominees Pty Ltd v Thomas & Or* [2101] QSC 417[5].

(c) Where trust deeds enable the distribution of income of a particular type to one or more beneficiaries, or one or more classes of beneficiaries, the taxation system should not operate to adversely impact on the full consequences (including specific taxation consequences) flowing through to the beneficiaries, or class of beneficiaries. This should be the case regardless of whether entitlement to a specific type of income is entrenched in the terms of the trust deed itself, or is determined at the discretion of the trustee, again within the terms of the trust deed.

(d) The proposed interim measures provide specific clarification for the tax treatment of franked dividends and net capital gains, only. The Committee acknowledges that this is an interim measure intended to provide short-term clarity for those specific income-streams. However, the broader review of the taxation of trusts contemplated in the Discussion Paper should consider a general rule for the "flow-through"

[5] The question of whether franking credits, being a construct of statute, could form part of the income of the trust was also raised in that case, which goes to the definition of "income" in Part 2 of the Discussion Paper

of characteristics and attributes of all types of income, deductions offsets and concessions, if it is not possible to achieve that outcome as part of the interim review. In any event the interim measure might also be extended to enable flow through of the characterisation of other types of income such as interest or rental income.

(e) The interim measures relating to streaming are currently expressed to apply to the 2010-11 income year and later income years. The commentary in the Discussion Paper reflects the ambiguity present in this area and presents a current interpretation that would support flow-through treatment of those amounts, in any case. The interim measures introduced to clarify the retention of character attributes of franking credits attached to franked dividends and net capital gains should be introduced with retrospective effect (to the date of ability to amend an existing tax return). This would ensure the equitable implementation of these rules and prevent further unnecessary (and costly) dispute between the Australian Taxation Office and taxpayers (and their advisers) on issues of characterisation that should now be clear.

11. The Committee provides the following additional comments in relation to the specific questions raised:

11.1 **Question 1:** If income of the trust estate is defined according to tax concepts should the gross capital gain be included in income or only the net capital gain (after applying available discounts)?

(a) If income of the trust estate is linked to tax concepts, then it is appropriate that only the net capital should be included in the income calculation. If the intended consequence of using a tax income alignment methodology is to minimise the mis-match between trust income and tax income, then the amount included in tax income, being the net capital gain, is the appropriate amount to include in the new definition.

(b) This treatment would overcome the need for adjustments suggested in Example 9 of the Discussion Paper.

11.2 **Question 2:** Should all notional amounts (for example receipts or expenses) be excluded from a definition of distributable income based on the concept of taxable income, or are there some notional amounts that should be included?

(a) Careful consideration needs to be given to any notional amounts that are expressly included or excluded from any new definition of distributable income. Prima facie, such notional amounts should be able to form part of the net income and there should be an ability for a beneficiary to be presently entitled to them.

(b) A full analysis of all items of notional income and statutory deductions would be required to properly answer this question and it would be

expected that process would be undertaken if a definition of distributable income that links into the tax law definition of income is to be pursued.

(c) By way of example, only, franking credits that attach to franked dividend distributions should be included in the definition of distributable income, if it links into a tax law definition. Alternatively, this could be dealt with by ensuring that tax attributes that necessarily attach to a particular class of income (like franking credits to franked dividends) automatically follow the distribution of that class of income, without being specifically included in a new definition of distributable income. The flow of franking credits (either through distributable income, or a separate rule specifically enabling the statutory tax attribute to follow the distribution) is supported by the proposed streaming rules that will apply to that type of income. Either of these methodologies would overcome the need for adjustments suggested in Example 7 of the Discussion Paper. The inclusion of franking credits in a definition of distributable income, or to be dealt with by a specific rule ensuring tax attributes follow relevant income, is suggested only to provide an example and is not intended to propose an exclusive inclusion.

(d) Unless a complete analysis and consideration of all notional amounts is undertaken, with a clear policy and integrity reason for specific inclusion or exclusion, either all notional or statutory tax amounts should be able to be taken into account in calculating the distributable income (to best achieve minimisation of mis-match), or trustees should be able to elect which amounts are included or not, as part of the interim elective approach.

(e) As a practical matter some of the perceived difficulties of dealing with notional amounts may be dealt with by a simple drafting change to the definition of net income for the purposes of section 95 in the 1936 Act. This would not require the establishment of a minimum distribution benchmark in order for the tax allocation to operate.

Many deeds simply adopt the concept of net income for the purposes of section 95 in the 1936 Act as a basis to determine the income of the trust. In some cases as a default position or in some cases as the primary basis to determine the income of the trust. As a matter of drafting if the notional amounts were never included in the net income for the purposes of section 95 in the 1936 Act but attached to the income allocated to the relevant beneficiary then these concerns should be dealt with. It would not alter the tax outcome for the beneficiary or the trust. However, the concerns about whether the distribution of notional amounts may be made will not arise for these trusts. They do not become part of the income of the trust for the purposes of the deed so it no longer necessary to consider how they can be allocated. The allocation occurs as a matter of law where the beneficiary becomes entitled to the relevant income.

This may be a simple, practical way of dealing with this issue for many trusts without requiring the deeds to be altered, without a wholesale review of trust deeds and without a cost for taxpayers.

11.3 **Question 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) The interaction between the terms of a trust deed and any new definition of distributable income will need to be carefully considered. This is one of the reasons the Committee has suggested that the proposed interim approach be adopted on an elective basis only and that a timeframe for closer consideration of the taxation of trusts be developed to ensure the interim measure is replaced, as soon reasonably possible, with a more considered approach to the overall taxation of trusts and the impact of changing definitions for tax purposes.

11.4 **Question 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) No specific anti-avoidance provision should be required.

(b) The operation of the general anti-avoidance provision should be effective to ensure that the integrity of any proposed change is not compromised by specific manipulation of character of income to achieve a particular tax benefit.

11.5 **Question 5:** Even if a specific anti-avoidance provision were introduced to restrict the re-classification 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) Any amendments that seek to align the tax treatment with the distribution profile of a trust between income and capital beneficiaries would need to ensure that the new provisions could operate effectively, without a specific anti-avoidance provision overlay that would undermine the new rules.

(b) If a new definition of distributable income, combined with specific streaming provisions for capital gains, was introduced, it should be able to operate without the need for overarching specific anti-avoidance provisions that may impede the ease of application of those provisions.

11.6 **Question 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) Clarifying the operation of section 207-35(3), by using linking provisions or notes to relevant sections of Division 6, would assist to ensure the streaming provisions work effectively. Appropriate legislative amendments in Division 6 will assist in reducing the potential for double taxation and eliminating any arguments that franking credits cannot be distributed to one or more particular beneficiaries. Legislative amendment to clarify the interaction between section 207-35(3) and Division 6 would be best placed in the definitions in section 95, after any amendment made following the review contemplated in Part 2 of the Discussion Paper. Specific reference to Subdivision 207-B made in Division 6 would also assist in navigating the operation of the provisions.

11.7 **Question 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 a capital gain 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) Subdivision 115-C should apply after the application of Division 6 to the proportionate value of any net capital gain that is attributed to the beneficiary, but should not apply if, due to a specific allocation of trust income (either under the trust deed, trustee discretion or operation of law), a beneficiary has not and will not, in fact, received any entitlement to any part of a net capital gain from the trust..

(b) If a specific allocation of net capital gains has been made to one or more beneficiaries, then the streaming rules contemplated in the Discussion Paper should result in the net capital gains of the trust being proportionately shared between identified beneficiaries entitled to that type of income (either as a consequence of entitlements specifically provided in the trust deed, or as a result of the exercise of a trustee's discretion to allocate income). In this case, the current operation of Subdivision 115-C should operate effectively to apply the appropriate uplift and discount rate to relevant beneficiates. A statutory link from Division 6 would assist in applying this rule.

(c) Subject to the outcome of the review into the definition of distributable income contemplated in Part 2 of the Discussion Paper, amendments to Subdivision 115-C should be made to ensure that any beneficiary that is not entitled to a distribution of net capital gains, through the operation of the trust deed, trustee discretions or legislation, should not be subject to Subdivision 115-C.

11.8 **Question 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) The trust entitlements of beneficiaries should be the source of any application of Part 3-3 or (more specifically) Subdivision 115-C. Following any amendment to the definition of income, as contemplated in Part 2 of the Discussion Paper and the introduction of legislation to

confirm the effectiveness of streaming net capital gains between beneficiaries of a trust, Subdivision 115-C should be amended to ensure that the uplift and discount mechanism contained in that Subdivision only applies in respect of income of beneficiaries of a trust that are actually entitled to a share of the net capital gains of the trust.

The Committee trust these comments and submissions are of assistance. The Committee welcomes the opportunity to participate in these important reforms as they progress. Please do not hesitate to contact the Committee Chair, Teresa Dyson, on 07 3259 7369 should you wish to discuss any of these submissions, comments or general observations further.

Yours sincerely

Bill Grant
Secretary-General

ANNEXURE A

OPTION ONE - ALIGNING DISTRIBUTABLE INCOME AND TAXABLE INCOME BY DEFINING DISTRIBUTABLE INCOME USING TAX CONCEPT

Positives	**Negatives/Issues**
To the extent that the excess of taxable income over distributable income reflects accretions to the trust estate (e.g. capital gains) the amount to be included in the assessable income of each beneficiary will reflect its entitlement to the amounts included in the net income of the trust estate. Similarly amounts which are not accretions to the net income but which have concessional taxation advantages such as franking credits (as in *Thomas Nominees Pty Ltd v Thomas & Ors* [6]) will also be included in the assessable income of the beneficiaries.	Some consider there is still some doubt as to whether beneficiaries can become presently entitled to amounts which do not reflect accretions to the trust estate (generally referred to as notional income)[7]. Such amounts include some amounts assessed under Part IVA (e.g. ***Grollo Nominees Pty Ltd v Federal Commissioner of Taxation***[8]) and increases in the capital proceeds (or decreases in the cost base) of a CGT asset under the market value substitution rules in Divisions 116 and 112 of the 1997 Act respectively. If so, such amounts will be included in the beneficiaries' assessable incomes in accordance with their respective present entitlements. Put another way the amount included in the assessable income of each such beneficiary would be greater than that to which it would be entitled under the trust. If not, they would be assessed to the trustee at the maximum marginal rate. In this case the issue may be addressed if such amounts were to be assessed under section 99 (which would involve other policy considerations).
Conversely, consistently with the scheme of Division 6 to assess the net income to the beneficiaries or the trustee[9], the excess of distributable income over net income will not be assessable to the beneficiaries[10] or the trustee.	
The opportunities for tax avoidance (such as in example 2 in Part 1.6 of the Discussion Paper) are reduced[11].	

6 [2010] QSC 417 (11 November 2010)
7 The doubt arises from the Court's comments in relation to present entitlement at p.506
8 (1997) 73 FCR 452
9 ***Federal Commissioner of Taxation v Tindal*** (1946) 72 CLR 608, 618
10 But could be assessable under other provisions such as s.6-5 ***(Tindal)*** or as giving rise to a net capital gain
11 See also the Commissioner's submissions in his application for special leave in ***Commissioner of Taxation v Cajkusic***

ANNEXURE B

OPTION 2 - DEFINING DISTRIBUTABLE INCOME USING ACCOUNTING CONCEPTS (SECTION 2.2.2 OF THE DISCUSSION PAPER)

Positives	Negatives/Issues
Accountants assisting with the administration of trusts and calculation of the tax consequences of a trust distribution (and hence their clients) may be able to work from a distributable income base that is consistent across all trusts. This may result in efficiencies in trust administration and reduced compliance costs.	The discussion paper acknowledges that if required to apply GAAP, it may result in increased complexity and compliance costs as not all trustees currently apply these principles in preparing annual financial statements for the trust.
	The discussion paper also acknowledges what seems to be the most fundamental disadvantage in these terms "there is a significant risk that because this approach is based upon accounting principles there will remain the possibility of substantial mismatches between distributable income and taxable income. The problem that the Government is seeking to address is often stated by accountants in terms of the permanent and timing differences between accounting profit and taxable income – so adopting accounting profit as the "distributable income" or "income of a trust estate" should not be expected to assist with the fundamental underlying problem in this area.
	Fixing the definition of distributable income as "accounting profit" may have the potential to produce outcomes in the current financial year which are different to that intended by those acting in effecting trust distributions before the proposals are enacted.
	Accounting profit is by nature not susceptible to precise definition and involves an exercise of judgement leading to potential uncertainties in determining the "distributable income" or "income of a trust estate"

ANNEXURE C

OPTION 3 – DEFINING DISTRIBUTABLE INCOME TO SPECIFICALLY INCLUDE CAPITAL GAINS

Positives	Negatives/Issues

• Many private trust deeds already give the trustee the discretion to determine what will be the distributable income of the trusts and/or will already include capital gains as part of that distributable income.
 	
Therefore, this minimalist approach will have least impact on the SME sector.
 	
• This approach provides some flexibility trustees to deal with anomalies that may arise as a result of a mismatch between section 95 net income and distributable income for reasons other than derivation of capital gains.
 	
The discussion paper acknowledges that the other options are likely throw up their own anomalies.
 	
However, under those more prescriptive approaches the trustee/tax payer will significantly reduced ability to deal with anomalous outcomes pending the proposed re-write.
	• This approach only deals with one of the potential anomalies arising from mis-matches between distributable income and section 95 net income.
	
	It does not deal with the issues that arise in where there is a difference in the two concepts (e.g. receipt of franked dividends or deemed Division 7A dividends).
	
	• Deeming capital gains to be included in distributable income may not provide meaningful assistance to trustees of trust estates where the trust deed does not permit distribution of capital gains to beneficiaries (e.g. testamentary trusts with different income and capital beneficiaries and managed trusts).
	
	  • For example even though a capital gain may be deemed to be part of distributable income for tax purposes, the terms of a Will or other trust instrument may not allow the trustee to distribute the gain component to the capital beneficiaries in the year of derivation leading to a section 99A assessment.
	
	  • With larger trusts, unitholders may be presently entitled to income but not capital gains (under the terms of the trust deed).
	
	  • Therefore, any amendment should provide that the trustee can choose whether to take advantage of the deemed inclusion of capital gains in distributable income.
	
	• If the intention is to reduce the extent of the mis-match between distributable income and section 95 net income –

Positives	Negatives/Issues
	the deeming provision should only include the net capital gain.. • There is no basis for inserting a specific anti-avoidance provision if this option is adopted. • The proposal makes minimal changes to the existing law and there is therefore no reason why a proposal to effectively maintain the status quo raises new avoidance opportunities. • Part IVA should be sufficiently robust to deal with any avoidance strategies. • To insert a specific anti-avoidance provision would involve a change in the law contrary to the expressed intention of the discussion paper. • Other options canvassed will also throw up anomalous results and the potential for manipulation and there is no suggestion of a specific anti-avoidance provision or those options

ANNEXURE D

ALTERNATIVE OPTION - ENTITLEMENTS UNDER THE TRUST DEED

The Committee provides the following alternative for your further consideration. Under this alternative, the taxable income of the trust is attributed to the beneficiaries of the trust according to each beneficiary's entitlement (as determined under the trust deed) to share in realised increases in the trust fund (that is, both income and capital) during the financial year. Under this approach the proportionate view will apply to determine the beneficiary's share of taxable income - on the basis that the trust is to be treated as a conduit for taxation purposes.

The key advantages of this approach are:

- it is consistent with the conduit nature of a trust; and
- there would be no requirement to redefine 'income' and 'capital' of the trust. That is, since any increase to which a beneficiary is entitled will be relevant for the purposes of allocating the taxable income of the trust.

For example:

Trust A has trust property that consists of shares in listed companies.

Beneficiary B1 is entitled to all of the income under the terms of the deed.

Beneficiary B2 is entitled to all of the capital under the terms of the trust deed.

The net income in FY11 is $70,000 and the taxable income is $100,000 after including imputation credits.

The value of the property increased by $100,000 during the FY11, but this 'gain' remains unrealised, since the property has not been sold during FY11.

During FY12 the gain on the property is realised. A capital gain of $100,000 arises.

The net income in FY12 is also $70,000 and the taxable income is $200,000 (being $100,000 capital gain and $100,000 grossed up dividend income).

The taxable income would be allocated as follows:

	FY11 – Trust entitlements	FY11 – Allocation of Taxable income	FY12 – Trust entitlements	FY12 – Allocation of taxable income
B1	70,000	100,000	70,000	100,000
B2			100,000	100,000
	70,000	100,000	170,000	200,000

The entitlements to income result in an allocation of that class of income to Beneficiary B1.

The entitlements to capital under the trust deed result in an allocation of the capital gain to beneficiary B2.

This is the same result that would arise where capital gains are included as part of distributable income. The proportionate view operates by class of entitlement so that the trust is treated as a conduit vehicle.

Further analysis about the specific application of this proposal to a broad range of scenarios would be required, but the Committee provides the following discussion and examples to illustrate the intended operation of this alternative.

For example:

Trust A has trust property that consists of commercial property which is leased.

Beneficiary B1 is entitled to all of the net rental income under the terms of the deed.

Beneficiary B2 is entitled to all of the capital under the terms of the trust deed.

The net rental income in FY11 is $50,000 and the taxable income is $45,000 after claiming Division 43 allowances.

The value of the property increased by $100,000 during the FY11, but this 'gain' remains unrealised, since the property has not been sold during FY11.

During FY12 the gain on the property is realised. A capital gain of $120,000 arises due to the reduction in the cost base of the building arising from Division 43 allowances (ss.110-45(1B), (4) and (6)).

The net rental income in FY12 is also $50,000 and the taxable income is $165,000 (being $120,000 capital gain and $45,000 rent after claiming Division 43 allowances).

	FY11 – Trust entitlements	FY11 – Allocation of Taxable income	FY12 – Trust entitlements	FY12 – Allocation of taxable income
	1	2	3	4
B1	50,000	45,000	50,000	45,000
B2			100,000	120,000
	50,000	45,000	150,000	165,000

The entitlements to rental income result in an allocation of that class of income to Beneficiary B1.

The entitlements to capital under the trust deed result in an allocation of the capital gain to beneficiary B2.

The Division 43 deductions may be more correctly allocated to the capital beneficiary. However, quarantining the deduction in this way may negate the statutory effect of the Division.

This is the same result that would arise where capital gains are included as part of distributable income – subject to any different treatment for Division 43 deductions. The proportionate view operates by class of entitlement so that the trust is treated as a conduit vehicle.

Positives	Negatives/Issues	Comments
Achieves an equitable 'conduit' allocation of taxable income based on entitlements to share in ‘realised’ increases in the trust fund during the financial year	The conduit treatment will not be fair unless a tracing exercise can be performed by the trustee and which is typically impracticable. Beneficiaries may be allocated a taxable income amount that is different in $amount from their entitlements under the trust deed.	
Avoids the need to redefine net income of the trust to align with a (new definition) for tax purposes. Avoids the need to distinguish receipts or payments as income or capital – unless required for streamed entitlements. Avoids the need to amend present entitlements under the trust deed to align with a (new definition) of distributable income for tax purposes.	All distributions from the fund (excluding contributed equity) will need to be accounted for. New subscriptions to the trust fund will need to be accounted for and excluded from any calculation of the increase in trust property.	

Positives	Negatives/Issues	Comments
Minimises the opportunity to manipulate the definition of distributable income since all accretions to the trust fund (that are not unrealised) will be relied upon to allocate the taxable income of the trust across all beneficiaries.	Unrealised gains to be excluded since these may not ultimately be realised and would not generally result in an amount included in the taxable income of the trust.	
Avoids the need to identify and monitor taxable income items that should be excluded from the definition of 'distributable income'	Creates a need to define 'realised' or 'unrealised' gains since unrealised increments in trust property (eg building appreciation) will not typically generate taxable income. Some (eg TOFA fair value elections and other mark to market exceptions) will need to be excluded from any definition of unrealised gains or included in realised gains.	
Minimises the potential impact on trust administration.		
Allows streaming for classes of income in accordance with the trust deed		The distinction between the proportionate quantum and hybrid views may still need to be resolved.
Should not require tracing – that is, a realisation of gains and a tracing of proceeds to underlying beneficiaries – provided 'the trust' is regarded as a genuine 'flow through' or tax transparent entity.	May require specific taxing provisions to be identified and amended to make clear that a conduit treatment is achieved when read in conjunction with section 97 of Division 6.	
Does not result in trustee being necessarily taxed on an amendment to taxable income and does not raise	Beneficiaries will be taxed on the taxable income of the trust	Any amendment to taxable income (eg self assessed or by ATO) will need to be allocated to beneficiaries or

Positives	Negatives/Issues	Comments
personally liability issues for the trustee where the tax arising on amendments to taxable income of the trust cannot be indemnified out of insufficient trust property		taxed to the trustee. The distinction between the proportionate quantum and hybrid views may still need to be resolved.
Beneficiaries will be taxed on the taxable income of the trust in accordance with a conduit approach	Tracing beneficiaries to advise of any amendment to taxable income may be difficult in non-family trust contexts where the amendment arises many years later.	The distinction between the proportionate quantum and hybrid views may still need to be resolved

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