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The General Manager
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The Treasury
Langton Crescent
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Dear Sir or Madam,

Re: Discussion Paper – Improving the taxation of trust income

First off, we would like to commend the Treasury on the steps that are being taken to provide more certainty in an area of taxation law that has plagued taxpayers and tax practitioners for decades and thank you for the opportunity to comment on the Discussion Paper – Improving the taxation of trust income ("the Paper").

The trust taxation regime has received wide coverage in the Courts and has created considerable debate amongst tax practitioners. This shows how difficult it is to interpret and advise on Division 6 of the Income Tax Assessment Act 1936 ("the Division") and the importance of reforms and/or legislature guidance to address the uncertainties in relation to the Division. We understand that more comprehensive reforms (including the rewrite of the Division) will follow and that the current review is of an interim nature and is only in relation to the following:

- "better align the concept of 'income of trust estate' with the tax law concept of 'net income of the trust estate'; and
- ensure that capital gains and franked distributions (including the attached franking credits) can be streamed to particular beneficiaries."

Whilst this is a commendable effort by the Treasury, we believe that it may be too optimistic to bring in new reforms which are earmarked to take effect for the 2011 income year. The relatively short consultation and drafting periods may not necessarily assist in minimising anomalous outcomes (which have been acknowledged in the Paper) that may result with the enactment of an interim approach to define the concept of 'income of trust estate'. Though these are proposed interim measures, we provide that decent time should be allocated to the consultation and drafting processes to ensure that these proposed measures do not result in a comparatively worse off scenario for taxpayers.

We note that while private entities such as family trusts generally benefit from an administrative discretion by the Commissioner of Taxation to extend the completion of their year-end distribution process, such discretion may not necessarily benefit public (listed) entities (such as the funds management industry) given that they have stringent compliance and reporting deadlines (other than tax-related) to meet. Any new net distributable income concept should be formulated with the view that the implementation of it should be quite straight forward to allow taxpayers (more importantly public (listed) entities) to meet their various deadlines.

Recommendation 1: Defining distributable income to specifically include capital gains

In our view, given the short time frame leading up to the 2011 income year end, we recommend that the concept of net distributable income should be determined according to the trust deed (i.e. as espoused by the judiciary). Adopting this option will prevent further uncertainties from arising and will

allow trustees to consolidate on existing practice. Given that it is an interim solution, this issue can be revisited when the rewrite of the Division occurs.

Please refer to Annexure A for a more elaborate discussion.

Recommendation 2: Streaming should be extended to all classes of income

We welcome the recommendation made by the Treasury that they will maintain past trust distribution practice and allow the streaming of capital gains and franked distributions. This should remove the uncertainty that was brought by the decision in *Bamford*[1] which resulted in a strict interpretation of the application of the proportionate approach. It was held that the proportionate approach applied to the trust income as a whole irrespective of how the different classes of income were distributed. In essence, this meant that beneficiaries would get taxed on a mix of different classes of income and resultantly no streaming could be achieved.

However, we note that the proposed measure should be broadened to ensure that any class of income can be streamed to any particular beneficiary as seen fit by the trustee and therefore should not be limited to capital gains and franked distributions only. Whilst we understand the rationale to stream capital gains and franked distributions, we do not see any reason why this should not be extended to other classes of income. We submit that the proportionate approach should apply on an income class by income class basis. This would maintain the trustee's discretion to appoint income to any particular beneficiary and allow income such as foreign income (and the associated foreign income tax offset) or personal services income to be streamed to the relevant beneficiaries.

If you would like to discuss our submission, please contact Yanese Chellapen on (03) 8635 1987 or ychellapen@macheladvisory.com.au.

Yours sincerely

Yanese Chellapen
Director
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[1] Bamford v Commissioner of Taxation [2010] HCA

Annexure A - Statutorily defining net distributable income

The concept of net distributable income (or as it is referred in the Division - 'income of a trust estate') is primordial in determining where the tax liability in relation to the 'income of the trust estate' should rest for a particular income year. Broadly, beneficiaries are assessed on their share of the taxable income of the trust in proportion to the net distributable income that they have received.

Where the whole of the net distributable income is not flushed out to the beneficiaries of the trust for a particular income year that undistributed amount will be subject to tax in the trustee's hands at punitive rate. The net distributable income concept has proven to be an abstract concept, which has led to different interpretations and uncertainties as to whether the right amount is being distributed to prevent trustee tax liability from applying.

To resolve this issue, the Treasury is proposing to impute a statutory definition to net distributable income.

The three alternative definitions are as follows:

1. Aligning net distributable income with taxable income ("Approach 1");
2. Aligning net distributable income with accounting concepts ("Approach 2"); or
3. Maintaining the current approach but including capital gains ("Approach 3").

Approach 1

This would be done by defining net distributable income to broadly mean taxable income but adjusted for relevant amounts (for instance inclusion of capital gains but excluding notional items – yet to be determined at this stage).

Whilst the merit of adopting this approach would be a more standard definition of net distributable income applying to trusts as a whole, we opine that its shortcomings make this approach unattractive and inflexible for taxpayers.

Calculating taxable income can prove to be an arduous exercise with not all tax information being available leading to and immediately after year end (for instance tax distribution statement) and this process may not necessarily be completed by the time that the trustee is required to exercise its discretion to distribute an amount. If this approach is to be adopted, trustees will need to be granted an extension to complete their distribution process for tax purposes. Given that the net distributable income will broadly be based on taxable income, the deadline can be extended to the lodgement due date of the trust tax return (which may not be necessarily feasible for public (listed) entities as mentioned above). In addition, there are issues like tax adjustments true-up and amended assessments that will need to be considered under this approach given that they are going to equally impact the calculation of net distributable income for tax law purposes and taxable income (compared to currently these only impact taxable income). We believe that this approach will create some mismatch for taxpayers with tax adjustments true-up and amended assessments both in the first year of implementation and going forward.

This approach makes the assumption that trustees have the necessary tax knowledge and therefore can work out the taxable income and the necessary adjustments to determine net distributable income. No doubt the accounting and/or legal professions are just a phone call away to assist but the onus is on the trustee to determine the net distributable income and the amount that the trustee wants and is willing to distribute should not necessarily be a tax driven concept. Making net distributable income a tax driven concept will create inflexibility and will hinder public (listed) entities from announcing the expected distributions for the year given that these distributions will hinge on taxable income and it will be hard to accurately estimate taxable income.

Adopting this approach means that trustees will generally have two different net distributable income amounts to deal with – 1) as ascertained under trust law and 2) as provided by the tax legislature. Although the mismatch between net distributable income and taxable income is being minimised with this proposed approach, another mismatch may be created between trust law net distributable income and tax law net distributable income. This means that to satisfy the new proposed measures, trustees will either have to over distribute in the event that the tax law distributable income is greater than trust law net distributable income or risk being exposed to punitive tax because they cannot fund the additional required distribution or are not allowed to under the trust deed. One possible solution is to amend the trust deed to ensure that the definition of net distributable income in the trust deed espoused the one provided for in the tax legislature. However, this solution raises further difficulties for instance whether there is any resettlement issue, the short time frame that trustees have to seek legal advice and amend the trust deed in the implementation year and more importantly whether it is a worthwhile exercise for a measure that is interim in nature and may be short lived (a proposed managed investment trust taxation regime has been foreshadowed and is expected to be in operation from 1 July 2011 which will generally exclude management investment trusts from the operation of the Division and as alluded to in the Paper a more elaborate review of the Division will follow that may reverse the proposed new measures). The comments made in this paragraph are equally applicable to Approach 2.

In addition, though the list of adjustments to notional items is not yet known, it is safe to assume that the list will be an extensive one and this will undoubtedly add a layer of complexity to year end distribution or even create further uncertainty if the list is not exhaustive in nature.

This approach may negatively impact on 'tax deferred' and/or tax free distribution. With Approach 1 aiming to reduce the mismatch between net distributable income and taxable income, there may be little or no excess over the taxable income to distribute for some trusts. This will make investment vehicles (such as REITs) less attractive to investors given that there is little or no 'tax deferred' or tax free incentive. Caution should be exercised in determining whether Approach 1 is commercially viable and we recommend that adjustments to be made under this approach should cover tax items such as Division 40 & Division 43 claims and capital gains tax concessional amounts to maintain the attractiveness of trust structures.

Approach 2

It is being proposed that this would be accounting profit as calculated in accordance with the generally acceptable accounting principles ("GAAPs").

In addition to reasons highlighted above as being applicable to Approach 1 and Approach 2, we are of the view that this approach will be hard to implement. At this stage, it is not yet known as to the exact accounting framework that trusts will need to follow to work out their net distributable income. It is very likely that some trusts will need to have parallel financial reports to cater for this new requirement given that some trusts would be operating under AIFRS whereas discretionary trusts will have far less stringent financial reporting requirements in place. This will create some imbalance for some trusts from an accounting view point and again with the tight deadline and the 2011 financial year drawing to a close, this approach is not seen as the right one.

There is also the risk that the net distributable income under Approach 2 will contain notional amounts that may not be able to be distributed and therefore this may make the trustee subject to punitive tax. It begs the question as to whether this approach will require the carving out of those accounting fictional items.

Adopting this approach also raises the issue that capital gains may not necessarily form part of the GAAPs accounting profit and therefore the aim of reducing the mismatch between net distributable income and taxable income will certainly not be achieved by leaving capital gains out of the equation.

Approach 3

We opine that this approach is the most appropriate on the basis that the concept is an existing one and therefore there will not be any implementation lag given the short time frame available.

However, legislature clarification should be provided to support the view taken by the Courts that net distributable income is income according to trust law (i.e. as defined by the trust deed) and that reliance should be placed on the distributable income definition where the trust deed contains both 'income' and 'distributable income' definitions.

We do not necessarily agree with the proposal that specific anti-avoidance provisions should be developed to target abusive trust distribution practices to shelter income from being subject to tax. We believe that the general anti-avoidance provisions (Part IVA) will be sufficient to deal with any tax mischief. However, we note that administrative guidance should be provided by the Australian Taxation Office ("ATO") as to when the ATO will seek to apply Part IVA and that the guidance should be drafted in concert with tax practitioners.

Lastly, the impact, on trusts with different income and capital beneficiaries (for instance hybrid unit trust), of adopting either Approach 3 or Approach 1 should be considered. The fact that capital gains will be reclassified as trust income for tax purposes may not work in practice with a hybrid unit trust. This will require that all the trust income (including capital gains) be flushed out to income beneficiaries, more so in the event that amendment is made to the trust deed to align trust law net distributable income and tax lax net distributable income. Caution should be exercised that structure such like a hybrid unit trust do not unintentionally become redundant, which may require the involuntary unwinding of investments held by these structures.