M L BRABAZON SC
Seven Wentworth, 180 Phillip St, Sydney 2000
DX 399 Sydney

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

Ref: Michael Bradshaw

Dear Sir,

**Discussion Paper: Improving the Taxation of Trust Income**

I refer to Treasury's publication on 4 March 2011 of a Discussion Paper, *Improving the Taxation of Trust Income*, and offer the following submissions for consideration.

1. The amendments proposed in the Discussion Paper are only intended to operate as short-term corrective measures pending a wider review of the general trust taxation rules under the *Income Tax Assessment Act 1936* (ITAA 1936) Pt III Div 6 and trust-related CGT rules. They are intended to minimise anomalous allocation of tax burdens, to minimise scope for tax avoidance by manipulation of the present rules, and expressly to permit and facilitate streaming of trust capital gains and dividends to the particular beneficiaries who are beneficially entitled to the gain or dividend in question. It follows that the amendments should not attempt a wholesale departure from existing rules, including the proportionate approach confirmed by *FCT v Bamford* (2010) 240 CLR 481, and should strike a balance between simplicity and comprehensiveness.

2. The first proposal of the Discussion Paper is that the income of a trust estate should be defined. The second is that explicit rules should be enacted to permit and facilitate streaming of (a) capital gains and (b) dividends, including franking credits. These can be taken as given.

3. Implicit in the Discussion Paper is a general principle that the person who is enriched by an item of trust income or gain should bear fiscal responsibility for it, if that person can be definitively identified (ITAA 1936 ss 97, 98, 98A, 100), failing which fiscal responsibility should fall upon the trustee and thereby the trust estate (ITAA 1936 ss 99, 99A). In this sense, fiscal responsibility for an item implies that the fiscal attributes of the item should flow through to the responsible taxpayer, including CGT concessions and franking credits. Implementation of the general principle is subject to limitations noted at (1) above.

4. Attribution to beneficiaries under present rules depends on the concept of present entitlement to income of the trust estate. Present entitlement is defined in a way that is functionally equivalent to an indefeasibly vested quantifiable interest (ITAA 1936 s 95A(2)). This provides the standard of definitive identification referred to at (3) above. There is no suggestion that the standard be changed.

5. There is a logical tension between the general principle referred to at (3) and the proportionate approach referred to at (1). The proportionate approach seeks to smooth


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out differences between amounts that are definitively allocated to beneficiaries year by year (referred to in the Discussion Paper as distributable income) and corresponding taxable income (s 95 net income of the trust estate). Taking account of *Bamford*, the Discussion Paper points to two important areas where this breaks down. First, taxable income includes capital gains to the extent that they are treated by tax law as being realised in the subject income year, subject to certain CGT concessions and adjustments, whereas the income of a trust estate which is used by Div 6 as the basis for the attribution rule does not pick up capital gains in any form unless (a) the terms of the particular trust depart from conventional trust principles either in their definition of trust 'income' or (b) the terms of the trust permit recharacterisation of capital gains as income and the trustee exercises that power in a particular way. Secondly, the capacity of a trust deed to mandate or permit recharacterisation between income and capital facilitates tax avoidance by manipulation of that boundary and/or by discretionary allocation between beneficiaries year by year. Short term measures can focus on removing the more serious anomalies and risk to revenue, but cannot be expected fully to resolve the underlying tension.

6. The Discussion Paper identifies three potential methods for defining income of a trust estate: first, to define by reference to tax income concepts, subject to adjustments which would have to be specified; secondly, to define by reference to generally accepted accounting principles (GAAP); thirdly, to include capital gains. These proposals share one common feature, namely, the adoption of criteria that operate objectively and without regard to the terms of the particular trust. Such a feature is desirable because it serves to minimise scope for tax-driven manipulation.

7. It is submitted that the income of a trust estate should be defined by reference to existing trust principles. It should not be defined by reference to tax law concepts because that exercise would be too complex and far-reaching for the kind of amendments that are proposed. The drawbacks of this first method are identified in section 2.2.1 of the Discussion Paper. Whilst it may be possible to reconsider this approach in a general review of Div 6 taxation, it is not viable as a short term measure. For similar reasons, GAAP should not be used. Trusts are already governed by a separate set of accounting principles which have developed over several centuries as an incident of general trust law, and which are distinct from general commercial accounting standards and rules. In addition, trustees must have regard to tax accounting both in the filing of trust returns and in considering the exercise of their functions as trustees. Mandatory reference to GAAP would impose a third body of accounting rules on trusts. This would be excessively burdensome and (as the Discussion Paper correctly observes) would not resolve the mismatch between the income of a trust estate and its net income.

8. Having regard to the proposal for streaming of capital gains, the general principle that fiscal responsibility for trust income and gains should flow through to a person who has a corresponding definitive entitlement to the benefit of the income or gain, and the goals of minimising anomalies and manipulation, it is submitted that the income of a trust estate in Div 6 could best be defined as *the income of the trust estate determined in accordance with general trust principles, without regard to the terms of the particular trust, and the capital gains of the trust estate*. Where a trust estate has such capital gains for an income year, it follows (a) that any capital beneficiaries who have an indefeasibly vested interest in such gains, whether directly by the terms of the trust or by an exercise of trustees' discretion, will be potentially taxable under s 97, 98A or 100, and (b) that, to the extent that the interest of such beneficiaries falls short of the amount of the gains, the trustees will be potentially taxable under s 99 or 99A.

9. Defining the capital gains of the trust estate that should participate in calculation of income of the trust estate raises difficulties. Those difficulties arise regardless whether the trust income definition proposed at (8) above is adopted, and a statutory definition of

such capital gains will be required. The proposal to allow streaming of trust capital gains requires a rule to determine which capital gains are recognised, and in what manner. One possible approach is to include those capital gains which general trust accounting principles would treat as realised gains accruing to capital beneficiaries (a concept which engages notions of vesting but not the right to present distribution). Another is to define the included capital gains by reference to CGT concepts, even though the income component is not defined by reference to income tax concepts.

10. Streaming of capital gains raises particular issues that have to be taken into account not only in the streaming rule, but also in the rule for inclusion of capital gains in the income of a trust estate. In particular:

    (a) CGT timing rules attribute CGT events and resulting tax liability to particular tax periods which may differ from the period when the gain would be recognised for other purposes (GAAP or trust accounting). Streaming requires attachment of the tax consequences to a beneficiary who has an indefeasibly vested interest in the gain, even if that interest arises for trust purposes in a different tax period from the tax liability.

    (b) CGT rules treat some gains as realised which would be unrealised for trust purposes. Presumably streaming of gains would require that, if a beneficiary has an indefeasibly vested interest in the particular gain, that person (and not the other beneficiaries or the trust generally through the trustee) should bear corresponding tax.

    (c) CGT rules attach roll-over relief to some realised gains. This treatment should be preserved by streaming the relief to the affected beneficiary or trustee (depending whether it can be said that a particular beneficiary has an indefeasibly vested interest in the gain).

    (d) CGT rules apply a range of discounts, concessions and special treatments to particular gains. Presumably the intention is that these features should also be streamed.

    (e) The relationship between trust capital losses and capital gains requires consideration. Presumably a particular gain should not be offset by a particular loss unless both are properly attributed to the trustee or to the same beneficiary.

11. In addition to inviting comments on its general proposals, the Discussion Paper sets out eight questions on which specific comments are invited. Selective specific comments follow:

    (a) Question 1: Regardless how the income of a trust estate is defined, capital gains should be included in that concept on a gross basis, with discounts and other adjustments applied in the hands of the taxpayer (whether a beneficiary or the trustee) to whom the item is streamed. If this is done, CGT concessions given to a 'trust' would need to be removed, ensuring that they are re-applied at the level of the beneficiary or trustee, as the case may be.

    (b) Question 4: If the income of a trust estate is defined objectively and without regard to the terms of the particular trust, no specific anti-avoidance rule should be required.

    (c) Question 5: It is not possible to achieve the objectives of the Discussion Paper without including capital gains in the income of the trust estate. Once that is done, any included capital gains that are not streamed to particular beneficiaries should generally result in an excess of income of the trust estate over beneficiaries' present entitlements. The streaming rule for capital gains should be so expressed as to ensure

that excess unallocated capital gains are streamed to the trustee, not the beneficiaries. This will result in taxation at the trustee rate, less any applicable discounts. Whilst this may cause some inconvenience, it would appear to be justifiable as a short term measure. It is practically universal and commonplace for trust settlements to contain powers of advancement that allow allocation of particular capital items, including gains, to particular beneficiaries. Statutory powers of advancement also exist (e.g. *Trustee Act 1925* (NSW) s 44). Such powers should enable trustees to avert excessive taxation.

(d) Question 7: Sub-div 115-C should be replaced. CGT discounts should apply at the level of the taxpayer, whether beneficiary or trustee. This should be achieved by the combined operation of the capital gains streaming rule and a new discount rule. See 10(d) and 11(a) above.

12. The general proposals and specific questions in the Discussion Paper do not address international taxation issues, such as the position of an attributable taxpayer in relation to a transferor trust or the international streaming of particular trust income or gains. These issues require consideration.

13. Finally, it is understood that the amendments are proposed to take effect for the income year ending 30 June 2011. It is now March 2011. The amendments cannot avoid a degree of complexity. Drafting and passage through Parliament will take time. It will be difficult for trustees to come to terms with the new measures, whatever form they take. Consideration should be given to a special transitional measure allowing trustees additional time to make determinations which are effective for the 2011 income year after the end of that year. The cut-off date for such determinations should be sufficiently generous to enable trustees to give mature consideration to the effect of the amendments after their enactment or, at the least, after their final form is publicly known. Apart from the compelling case for a special transitional measure, there may also be a good case for enactment of a general statutory period after the close of an income year during which trustees can make determinations that will be recognised for purposes of Div 6 present entitlement in relation to that year.

Yours faithfully,

M L BRABAZON.