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

By email: sbtr@treasury.gov.au

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RE: Improving the taxation of trust income – Discussion Paper

Dear Sir/Madam,

We thank you for the invitation to comment on the discussion paper regarding the proposed measures to improve the taxation of trust income.

As we have only had two weeks to consider these materials and make our submission, we will be relatively brief with our initial views on these measures, and will consider each separately.

1. Better aligning the concepts of distributable income and taxable income

As a starting point, we fully recognise that the situation highlighted in Example 1 in the discussion paper is untenable and needs to be fixed. This situation can be avoided by most modern trust deeds that would allow the capital gain to be included in the income of the trust (whether automatically via an "equalisation clause" or by a power allowing the trustee to determine that the capital gain was income, as confirmed by the High Court in *Bamford*). However, where a deed does not provide this power, we acknowledge that, without legislative change, this solution is not possible and the results in Example 1 would follow.

Regarding Example 2 in the discussion paper, we would question (a) how prevalent this situation is, (b) whether it is possible at all, in light of the comments of the Full Federal Court in its decision in *Forrest v FCT [2010] FCAFC 6*, and (c) why Part IVA would not apply to such an arrangement in any event (it appears clear that it would involve a scheme with the sole or dominant purpose of obtaining a tax benefit). Nonetheless, we recognise the Government's desire to put such an issue beyond doubt.

Regarding the possible approaches the Government could take to rectify and clarify these situations, at this stage we agree with the approach recommended under heading 2.2.1 (we must reiterate that, given the limited time to formulate a response, this is our

preliminary view, and we have not worked through the possible permutations of each possible approach).

That is, the definition of 'distributable income' should be equated with 'net income' (perhaps modified by certain amounts, though if our below suggestion is accepted, this may not be necessary). We think the increased complexity and compliance costs for trustees and beneficiaries of trusts will be offset by the greater certainty afforded by this proposal, as well as the other benefits set out on page 9 of the discussion paper.

The biggest problem we see with this is that this approach "may mean there is an amount of income to which no beneficiary is presently entitled – and therefore an amount of taxable income assessed to the trustee". We propose a possible solution to offset this problem: if a trustee has distributed all of the income that it has the power to distribute (or has made reasonable efforts to distribute all of the income of the trust but despite those efforts has not succeeded in doing so), then the trustee would be liable to pay tax on the balance under section 99 of the ITAA 1936, rather than section 99A. This would remove the penalty aspects of these provisions, but still ensure the amounts are taxed in some way (and there will be certainty about where the tax liability lies). This solution would ensure that the problematic effects in the Example 5 regarding the 27% of 'distributable income' of the trust to which no beneficiary was presently entitled, and on which the trustee would be assessed, would be minimised.

As a further point, we query whether it would be possible for the ITAA to specifically provide trustees with the power to distribute franking credits (and other notional amounts for tax purposes) irrespective of what the deed states, at least for tax purposes. This may require the law to explicitly state that actions taken by trustees in accordance with the legislation may be done notwithstanding the existing terms of the trust deed (akin to section 90AC of the *Family Law Act 1975*) and without any risk of action being taken by any party for, e.g., breach of trust. As this is entirely a taxation issue, then the trustee should be able to comply with its taxation obligations within the confines of the tax law, and we hope that these issues can be fixed by amending the taxation law without needing to go beyond into trust law or amending trust deeds. However, we acknowledge that this may create further problems and that the Government is looking for a solution which may be implemented as soon as possible.

Whilst on that point of keeping this issue within the bounds of taxation law, we submit that the proposal under heading 2.2.2 (to define distributable income using accounting concepts) is an imperfect solution, which would introduce further complexity without fixing the core issues, which are purely taxation issues.

Regarding the proposal under heading 2.2.3 to introduce a specific anti-avoidance provision, we are not against this proposal per se, though we submit that the general anti-avoidance provisions in Part IVA should be sufficiently robust to combat deliberate manipulations of the kind contemplated in the discussion paper (and also note that the Government has announced that these provisions will also be reviewed, so perhaps they could be reviewed with the particular requirements of the trust provisions also in mind).

However, we do have a specific problem with the entirety of this proposal, and that is the timing. Despite the fact that the Board has advised that this issue must be addressed in the current year for the laudable goal of "certainty", this measure has actually made things more uncertain for the current year. We currently have seminars around the country where members (largely comprising accounting firms) are asking for guidance about how trusts should resolve to distribute their income for the current income year (which must be done by 30 June 2011), and we had developed workable solutions to the problems that arose as a result of the Bamford decision (which, arguably, were always present). However, now that the Government has proposed to change the law for the current year but doesn't yet know what form that change will take has meant that our members are even more confused and concerned about best advising their clients. We have no doubt this confusion is manifest in the wider community.

We would submit that, by the time the final course of action has been decided upon (possibly after further consultation) and legislated, trusts will not have had enough time to understand and apply those changes for the current year (if, indeed, the legislative change even occurs by 30 June).

Therefore, we submit that this change be delayed to the following income year, giving accountants and their trust clients the time to properly understand and implement the legislative change (which will no doubt be an enormous departure from the current understanding of how trusts are taxed and determine their taxation consequences).

Alternatively, if a change must be proceeded with for the current year, we request that transitional provisions be introduced for those trusts which rely on the pre-existing law, provided they do not attempt to manipulate their tax liabilities in the manner suggested in Example 2 in the discussion paper (although we again submit that Part IVA should adequately combat such a strategy).

2. Enabling the Streaming of Franked Distributions and Net Capital Gains

Very simply we agree with the entirety of these proposals.

As this measure would basically continue the existing practice of many trusts (i.e., most trusts and their advisers have assumed that streaming capital gains and franked distributions is effective, particularly in light of the ATO's tax ruling on the subject: TR 92/13 (which the ATO has stated it would withdraw after the 2009/10 income year, though it has not been withdrawn as at the date of this submission)), implementing this legislative change in the current income year should not result in any disruptions.

Our only issue with this measure is that it is limited in its scope to the streaming of capital gains and franked distributions. We understand that the reason for this is to clarify the current operation of Divisions 115 and 207, which imply that streaming of capital gains and franked distributions is acceptable without making it clear. However, many trusts have relied on the principles in TR 92/13 to stream other classes of income,

such as interest and foreign income. We ask whether the Government could consider amending the legislation to include a general provision that confirms that a trust may stream different classes of income, not just capital gains and franked distributions.

Summary

In summary, our submissions are that:

- the definition of 'distributable income' should probably be equated with 'net income', most likely modified by excluding certain notional amounts (though this option creates its own problems); however, this change should be further considered and either be made for the year commencing 1 July 2011, or (if the changes are made for the current income year) appropriate transitional arrangements should be made legislatively or administratively to allow for trusts that are not able to adequately implement the changes; and
- we support the express recognition of the streaming of capital gains and franked distributions in the current income year, and request that the Government consider extending this recognition to the streaming of other classes of income.

Thank you for your time.

Yours faithfully

Riley Jones
Legal Counsel for and on behalf of the National Tax and Accountants' Association