

# Submission re 2011 Interim Trust Law Measures

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- 1 In December 2010 the Assistant Treasurer announced a two-step process with a view to updating the trust income tax provisions.
- 2 Chronologically the first of these was to identify whether there were any issues with the operation of the provisions that needed to be addressed in the financial year ending 30 June 2011.
- 3 The second of these was to consider the broader issues to be considered in updating the trust income tax provisions.
- 4 In relation to the first proposal a Discussion Paper<sup>1</sup> was issued on Friday, 4 March 2011 with a focus upon two issues:
  - 4.1 the interaction between the distributable income of the trust, primarily determined by reference to the terms of the trust deed, and the tax law concept of 'net income of a trust estate'; and
  - 4.2 ensuring that capital gains and franked dividends can be streamed to particular beneficiaries.
- 5 It would appear that these two issues are integrated at least in relation to capital gains in that the direction is to ensure that, among other things, capital gains are included in the calculation of the distributable income of a trust and then allowed to be streamed to particular beneficiaries.
- 6 Submissions in relation to this discussion paper are due within two weeks. This is a very limited period of time for considered analysis by taxpayers and their advisers.
- 7 In relation to the broader review a further discussion paper is to be released "in the coming months"<sup>2</sup>.
- 8 One of the stated purposes for the reforms that will emanate from the consultation surrounding the Discussion Paper is to provide taxpayers with increased certainty. As these measures are to operate for the current financial year, it would be surprising if the relevant legislative amendments could be passed through Parliament by 30 June (at the latest). How will taxpayers be given sufficient certainty regarding the amendments so that they can be relied upon for the current financial year?
- 9 In the context of the prior point, it needs to be remembered that there are a variety of trust alternatives including conventional discretionary trusts, conventional unit trusts, hybrid trusts, life estates, managed investment trusts and disability trusts to name a few. The Discussion Paper seeks to treat generically principles covering a variety of forms of trust and circumstances.
- 10 In terms of the interaction between distributable income and "net income of a trust estate", there is concern about anomalous outcomes and opportunities to manipulate. Putting to one side for a moment the need to address anomalous outcomes, has considered attention been given as to whether other provisions of the Taxation Law satisfactorily address "opportunities for manipulation"? The only example given (Example 2 on page 5) deals with an exempt entity being assessed

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<sup>1</sup> Titled – "Improving the taxation of trust income"

<sup>2</sup> Per the Foreword to the Discussion paper

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on amounts received by capital beneficiaries. At first blush, one would have thought that it is not too difficult to identify a counterfactual that would facilitate the identification of a tax benefit and a dominant purpose to avoid tax as a consequence of which the general anti-avoidance provision in Part IVA would have application.

- 11 To this point, it is evident that the issues under immediate consideration are part only of a much broader review; those issues are being considered in a very tight time frame; and it is going to be difficult in that tight time frame to ensure that the interim legislative amendments are fully considered so as not to exacerbate the existing uncertainty by bringing into existence more anomalies and inadvertent outcomes.
- 12 The three alternatives regarding the definition of distributable income still leaves open the serious possibility for mismatches between entitlements and tax liabilities arising because of the application of the proportional theory.
- 13 We strongly recommend that a more appropriate approach would be to incorporate these interim issues into the broader reform review and to then conduct that review over an appropriate time frame so that there is full consideration of the issues thus producing the prospect of a reform outcome that enhances rather than further complicates the taxation system.
- 14 As an interim measure, the following would operate effectively -
  - 14.1 The existing anti-avoidance provisions should be applied to "manipulation" of the type set out in Example 2.
  - 14.2 In relation to the two streaming issues raised, with the goodwill of the Australian Taxation Office, at worst, it should be possible to apply interim non-binding administrative concessions intended to ensure that capital gains and franked dividends<sup>3</sup> can be streamed for particular beneficiaries.
- 15 In relation to the alternatives to align distributable income with taxable income, consideration needs to be given to the fact that trustees are obliged, under the taxation system, to resolve their distributions on or by the 31 August following the relevant 30 June.
- 16 Also in relation to the alignment of distributable income and taxable income, regard must be had to the existing terms of the trust deed. Particularly where it does not have an income equalisation clause or a re-classification clause, it may be difficult to satisfy the definition of distributable income.
- 17 The proposal to define distributable income using tax concepts acknowledges the need for possible adjustments so that, broadly, "the taxable income of a trust will need to be adjusted to reflect the actual amount available for distribution..."<sup>4</sup>. There are then a limited number of possible adjustments identified including franking credits, deemed dividends, Division 41 deductions and possibly the discount amount of a net capital gain. It seems that there are potentially many more adjustments including attributable income under the foreign source income provisions, non-deductible expenses, black hole expenses not covered by Section 40-880,

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<sup>3</sup> Per Point 20 below, it appears that a Public Ruling could be released confirming the acceptability of streaming franked dividends

<sup>4</sup> Page 10

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accelerated depreciation, timing differences such as employment provisions and accrued income etc.

- 18 In relation to the proposal to define distributable income by reference to generally accepted accounting principles, the following is noted -
- 18.1 Most trusts are not presently required to adopt such principles;
  - 18.2 A significant feature of generally accepted accounting principles is to recognise unrealised amounts. Consequently, a large component of the profit or loss may be unrealised and particularly in the context of profit not be available for distribution;
  - 18.3 If the Trust Deed does not permit the Trustee to distribute the whole of the amount that is taken to be 'distributable income', 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;
  - 18.4 In relation to unit trusts, if the application of generally accepted accounting principles is to recognise unrealised profits then this is likely to create CGT event E4 issues;
  - 18.5 In the context of life estates, the distinction between income and capital beneficiaries is usually absolute and non-discretionary and defining distributable income by reference to generally accepted accounting principles will in fact run counter to the purposes of such trusts.
- 19 In relation to the proposal to define distributable income to include capital gains, the following is noted -
- 19.1 What is intended where the capital gain is a discount capital gain? Is it the whole of the capital gain that must be distributed or the discount amount?
  - 19.2 This alternative has the additional advantage of possibly avoiding a trustee assessment where the trust makes a capital gain for an income year but has no other income.
  - 19.3 The Discussion Paper at page 12 states that "...where the trust's deed does not include any capital gains made by the trust in its distributable income, these amounts could be included for tax purposes." With respect, this is a vague statement and needs to be supported by an example as to precisely what is intended.
  - 19.4 With regard to the comment that a specific anti-avoidance provision may also be required, the comments above regarding whether this is truly necessary or whether existing provisions would operate effectively needs to be considered;
  - 19.5 As noted previously, in the context of the life estate, the distinction between income and capital beneficiaries is usually absolute and non-discretionary and thus inconsistent with this proposal;
  - 19.6 The primary purpose of incorporating capital gains into the definition of distributable income is ostensibly to avoid beneficiaries being taxed on

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amounts to which they are not entitled. Without complicating the legislative provisions still further by amendment to Section 97, it would seem possible that this mismatch could be overcome by enshrining in legislative form PS LA 2005/1 dealing with the taxation of capital gains of a trust. This PS LA operated very effectively prior to its withdrawal and in a pareto context dealt with most concerns.

- 20 In Appendix One, we have sought to identify by reference to each of the three distributable income options and by reference to the more typical forms of trusts the advantages, disadvantages and other matters that have arisen in our analysis.
- 21 In relation to Part 3.1 of the Discussion Paper, the Paper cogently sets out that it appears that it was always intended that relevant provisions within Subdivision 207-B appear to codify that that Subdivision overrides Division 6. Further, it is hard to imagine that the Act would intend to tax franking credits twice. It seems that what arises here is a proposed legislative amendment that could be dealt with by way of a Public Ruling. That Public Ruling could have incorporated into it, among other things, Example 7 for example.
- 22 In relation to the streaming of net capital gains, will there be a provision similar to that in the imputation provisions that contemplates the flow of capital gains through more than one trust?

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## Appendix One

Alignment of Distributable Income and Taxable Income				
	Equate distributable income with the 'net income of a trust estate' (as defined in section 95) — adjusted by relevant amounts.			
	For <sup>5</sup>	Against <sup>6</sup>	Comments/Issues/Questions	
Conventional discretionary trusts including testamentary trusts that are drafted analogously to a conventional discretionary trust	<ul style="list-style-type: none"> <li>reduce the scope for beneficiaries to be subject to tax on amounts they are not entitled to;</li> <li>may avoid a trustee assessment where the trust makes a capital gain for an income year but has no other income;</li> <li>builds on existing concepts that would be familiar to many tax professionals;</li> </ul>	<ul style="list-style-type: none"> <li>as this approach relies on adjusting the taxable income of the trust to calculate distributable income, it may result in increased complexity and compliance costs;</li> <li>it may also necessitate amendments to ensure that the trust's exempt and non-assessable non-exempt income is allocated appropriately amongst beneficiaries with entitlements to those amounts;</li> <li>if the trust deed does not permit the trustee to distribute the whole of the amount that is taken to be 'distributable income' by virtue of the legislative definition (as either income or capital), 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.</li> </ul>	It is not clear how this concept interacts with the "proportional theory" (franked dividends and capital gains aside) – particularly where different parties are entitled to different sources	
Unit trusts with one class of units and all unitholders benefiting on a pro rata basis				
A life estate				It is not clear how this concept interacts with the "proportional theory" (franked dividends and capital gains aside) – particularly where different parties are entitled to different sources

<sup>5</sup> Per Discussion Paper and allocated to the different classes of trust

<sup>6</sup> Per Discussion Paper and allocated to the different classes of trust

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## Appendix One

Alignment of Distributable Income and Taxable Income			
	Define the concept of distributable income with reference to generally accepted accounting principles.		
	For <sup>7</sup>	Against <sup>8</sup>	Comments/Issues/Questions
Conventional discretionary trusts including testamentary trusts that are drafted analogously to a conventional discretionary trust	<ul style="list-style-type: none"> <li>may reduce the scope for beneficiaries to be subject to tax on amounts they are not entitled to under trust law;</li> <li>builds on existing concepts that would be familiar to many tax professionals;</li> <li>incorporates relevant expenses, meaning the defined concept of distributable income would reflect that income that is available for distribution.</li> </ul>	<ul style="list-style-type: none"> <li>as this approach will require all trustees to apply GAAPs it may also result in increased complexity and compliance costs as not all trustees currently apply these principles;</li> <li>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.</li> </ul>	<p>Most trusts are not presently required to adopt GAAP.</p> <p>The comment that the approach “incorporates relevant expenses, meaning the defined concept of distributable income would reflect that income that is available for distribution, does not recognise that a significant feature of GAAP is to recognise unrealised amounts. Consequently a large component of the profit or loss may be unrealised.</p> <p>If the trust deed does not permit the trustee to distribute the whole of the amount that is taken to be ‘distributable income’ by virtue of the legislative definition (as either income or capital), 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.</p> <p>It is not clear how this concept interacts with the “proportional theory” (franked dividends and capital gains aside) – particularly where different parties are entitled to different sources.</p>
Unit trusts with one class of units and all unitholders benefiting on a pro rata basis			Unrealised profits are likely to create CGT event E4 issues.

<sup>7</sup> Per Discussion Paper and allocated to the different classes of trust

<sup>8</sup> Per Discussion Paper and allocated to the different classes of trust

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### Appendix One

A life estate	<ul style="list-style-type: none"><li>• builds on existing concepts that would be familiar to many tax professionals;</li></ul>		The distinction between income and capital beneficiaries is usually absolute and non-discretionary.  Otherwise as for Discretionary Trusts.
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Alignment of Distributable Income and Taxable Income			
	Define distributable income to include capital gains.		
	For <sup>9</sup>	Against <sup>10</sup>	Comments/Issues/Questions
Conventional discretionary trusts including testamentary trusts that are drafted analogously to a conventional discretionary trust	<ul style="list-style-type: none"> <li>reduce the scope for beneficiaries to be subject to tax on amounts they are not entitled to;</li> </ul>	<ul style="list-style-type: none"> <li>a specific anti-avoidance provision may also be required to ensure that the tax liabilities of beneficiaries of the trust cannot be manipulated.</li> </ul>	Relatively simple.
Unit trusts with one class of units and all unitholders benefiting on a pro rata basis			<p>What is intended where the capital gain is a discount capital gain?</p> <p>May avoid a trustee assessment where the trust makes a capital gain for an income year but has no other income;</p> <p>If the trust deed does not permit the trustee to distribute the whole of the amount that is taken to be 'distributable income' by virtue of the legislative definition (as either income or capital), it is intended that capital gains "... could be included for tax purposes."<sup>11</sup></p> <p>Builds on existing concepts that would be familiar to many tax professionals;</p> <p>It is not clear how this concept interacts with the "proportional theory" (franked dividends and capital gains aside) – particularly where different parties are entitled to different sources.</p>
A life estate			<p>The distinction between income and capital beneficiaries is usually absolute and non-discretionary.</p> <p>Otherwise as above.</p>

<sup>9</sup> Per Discussion Paper and allocated to the different classes of trust

<sup>10</sup> Per Discussion Paper and allocated to the different classes of trust

<sup>11</sup> Page 12;



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Appendix One