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TF:DB — OUR REFERENCE

YOUR REFERENCE

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9 February 2012 — DATE

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

By e-mail to: trust_rewrite@treasury.gov.au

Dear Sir or Madam,

Modernising the Taxation of Trust Income – Response to Consultation Paper

I am pleased to enclose State Trustees' submission in response to Treasury's Consultation Paper.

We are aware that the Trustee Corporations Association of Australia, of which State Trustees is a member, is also proposing to make a submission, and we share that organisation's concerns around achieving sensible reform in this area. Given the particular focus of State Trustees' trust administration work, it is appropriate that we make a stand-alone submission.

State Trustees looks forward to contributing to Treasury's further consultations around this important area of the law.

If you have any queries please contact David Barber on 9667 6296.

Yours sincerely,

A G Fitzgerald
Managing Director

encl.

Modernising the Taxation of Trust Income
Options for Reform

November 2011

Submission in response to the Consultation Paper

by
State Trustees Limited

9 February 2012

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Abbreviations / Glossary

ATO	Australian Taxation Office
CGT	capital gains tax
Consultation Paper	Treasury Consultation Paper "Modernising the taxation of trust income – options for reform", November 2011
ITAA 1936	*Income Tax Assessment Act 1936* (Cth)
State Trustees	State Trustees Limited
TFN	tax file number
Victoria	The State of Victoria

A. Introduction - State Trustees and trust administration

State Trustees welcomes the opportunity to provide our submission in response to this important review of the current issues and complexities facing the taxation of trusts as discussed in the Consultation Paper.

As Victoria's public trustee entity, State Trustees plays a central role in providing estate planning, administration and related services to members of the Victorian public, especially those who do not have the resources to obtain those services for themselves.

Our broad range of services means we are a provider of trustee and trust administration services as a result of a number of our roles.[1]

In particular, our services related to this submission include acting as the trustee of around 3000 continuing personal trusts with an average value of around $60,000, each generally with only one beneficiary with current entitlements. In the main, these trusts arise from:

- deceased estates;
- statutory compensation such as workers compensation and accident compensation;
- insurance and superannuation benefits; or
- private settlements.

This generally includes circumstances where trusts are established for:

- beneficiaries with a disability and vulnerable individuals;
- minors;
- families; or
- charitable purposes.

The overwhelming majority of the trusts that State Trustees administers come about from a set of events or circumstances, such as the death of a parent or relative, rather than being established to manage aspects of commercial interests, to limit risk or to structure wealth-creation or income-tax advantages.

[1] Further information about these roles is set out in Appendix.

B. Executive Summary

The trusts we manage (see the Introduction, above) are rarely the subject of complex taxation or litigation issues (such as the "Bamford" case) but, nonetheless, are subject to the same tax laws which apply to all trusts (i.e. those found in Division 6 of the ITAA 1936, etc.).

At present, the tax laws contain numerous instances where complexity, a lack of formal definitions of terminology used, and a lack of cohesion with general trust law and principles causes significant confusion to our client beneficiaries, and significant compliance costs.

Under certain circumstances the action of our present tax laws can result in anomalous and seemingly unfair liabilities for tax on beneficiaries. The most common example is a "life tenant" beneficiary being liable for tax on capital gains which he or she is not entitled to receive under the terms of a will.

Accordingly, we welcome and encourage the objectives of the Consultation Paper and support positive steps to improve the laws relating to the taxation of trusts with the aim of providing a fairer, clearer and more certain approach to the taxation of income and capital gains derived by trustees.

We have provided comments on as many of the issues and questions raised in the Consultation Paper as we feel are appropriate given the nature of the majority of trusts we administer.

In particular, of the three potential models proposed in the Consultation Paper we believe the "Trustee Assessment and Deduction" model (**TAD Model**) has the greatest potential to provide a robust, simplified method of achieving appropriate assessment of trust income and capital gains while aligning with general trust principles.

C. Comments on the Chapters of the Consultation Paper

In the following sections State Trustees has provided comments under the headings of the chapters as they appear in the Consultation Paper. We have focused our comments on those questions and issues most commonly impacting the classes of trusts and beneficiaries for whom we act.

1 Introduction

State Trustees supports the objectives of the review listed at **1.2**. In relation to objective 5 we note the current work of the Business Tax Working Group on the treatment of company losses and suggest that, while companies and trusts should remain distinct, there may be advantages attained by including simplification of rules to the alignment of the treatment of losses for both companies and trusts.

In **1.3**, regarding the "Scope of the Review", State Trustees recognises the government's comments regarding possible delays of attempting to address all issues in a single process. We believe efforts to remove barriers to the fair and equitable assessment of tax *only against beneficiaries who can receive or benefit from the associated income* are the highest priority.

2 Taxation of trusts

We note the observation in **2.2.2** that most modern trust deeds provide trustees with some flexibility to determine a trust's distributable income, but in the main types of trusts State Trustees handles the terms of, say, wills that were written many years ago do not generally provide for such flexibility. (Often this is to ensure the testator's wishes are upheld by restricting the trustee's discretionary powers).

In **2.2.4** the Consultation Paper provides a definition of "present entitlement" and references certain circumstances which result in a beneficiary being taken to be presently entitled for tax purposes by virtue of the application of s 95A of the ITAA 1936.

We support the retention of the principle of Sec 95A(2) whereby a beneficiary with a vested and indefeasible interest (such as many minor or disabled beneficiaries) should be taken to be presently entitled to trust income notwithstanding they may not have a vested interest in possession. However, we note the concept of "present entitlement" is a vague one (see our further comments below).

3 Problems with the operation of Division 6

At **3.1** the Consultation Paper highlights the current uncertainty as to which trusts are subject to the operation of Division 6. State Trustees supports the intent to clarify which trusts are subject to which provisions of tax law, and that an individual trust should only be subject to the operation of one set of provisions – even if it is not possible to have *all* trusts subject to only a single set of provisions.

At **3.2** the Consultation Paper highlights key terms used in Division 6 which have no formal definition. State Trustees supports consolidation of these terms wherever possible, with supporting provisions and definitions to be provided. These should align with trust law and principles and have regard to the trust deed and relevant accounting principles.

We would add to the list the concept of "present entitlement" which can cause much confusion in determining when a beneficiary can be said to be presently entitled in the context of a deceased estate (where the answer turns on when the administration of the estate can be said to be complete). In a sense this dovetails in to the issue identified in **3.2.1** in that identifying the "trust estate" involves determining when a trust estate could be said to have commenced, which in turn depends on identifying the point where the administration of an estate can be said to have come to an end.

The discussion at **3.3** of the Consultation Paper highlights the area of greatest concern for State Trustees and its client beneficiaries – that being the potential for an anomalous tax liability to arise under a proportionate approach to the taxation of the taxable income of a trust against a beneficiary who is unable to receive or benefit from certain amounts.

In particular this difference between the distributable and taxable income of the trust arises in cases State Trustees administers for "life tenants" or "life beneficiaries" who have only an entitlement to the "trust income" which does not include capital amounts such as capital gains realised on the sales of assets.

Many trust instruments, such as wills and settlements, were written before the interactions of such investments with tax laws could have been envisaged and do not contain appropriate clauses to deal with these issues. Variation of these instruments is often not possible but, even where possible, can be expensive.

State Trustees favours the alignment of definitions relating to taxable income with (as the case requires) the distributable income available to beneficiaries (where there is 'present entitlement') and (where there is no such 'present entitlement') income that may be required to be retained by trustees in accordance with the trust terms and principles involved in the trust instrument.

3.4 highlights the very practical issue facing trustees who must determine the distribution of income annually on various trusts. Making a determination at 30 June

which is reasonably based on the needs and circumstances of the beneficiaries is frequently impractical when significant amounts and components of the trust income have not been identified at that date (for example, where the trust assets include interests in a managed fund that distributes 30 June amounts some time after 30 June).

State Trustees recognises there are real issues in determining what period, if any, after 30 June is appropriate to allow trustees to gather relevant information to allow a reasonable determination to be made as to the distribution of income. We believe the TAD Model would provide the appropriate solution to this problem. We note that it is implicit in that model that the point in time by which the trustee's determination would be required would be the earlier of (a) the date of lodgement of the trust tax return, and (b) the due date for lodgement of the trust tax return (subject to any extension granted by the ATO).

At **3.6** the Consultation Paper highlights the lack of legislative certainty provided to trustees in relation to a potential future tax liability which has not previously been assessed against the trustee. State Trustees favours a legislative amendment to provide trustees with the ability to obtain an assessment or "clearance" in relation to their taxation obligations, even where the trustee would not have a tax liability (based on the tax return lodged).

4 Interactions between Division 6 and other parts of the Tax Law

While we note the Consultation Paper refers in **4.1** to the interaction of Division 6 and the CGT provisions, it does not deal with what might be said to be the fundamental issue of whether the CGT provisions can apply to corpus distributions. We note the ATO does not apply the law in such a way, but the definition of a CGT asset is broad enough to include a beneficiary's right to the corpus of, say, a deceased estate.

We note in passing that the franked distribution rules referred to in **4.2** can cause problems with many deceased estates in that, technically speaking, their trustees need to make family trust elections in order to pass on the franking credits, but often the classes of beneficiaries are such that they cannot really do this. Back in 2002 the then Federal Government announced the law would be amended to remove this anomaly, but almost 10 years on it still remains.

At **4.7** the Consultation Paper discusses the interaction of Division 6 with the TFN Withholding Rules applying to "closely held trusts" introduced to Divisions 4A and 4B. Though these provisions are quite recent, State Trustees has noted that in cases where an adult beneficiary has not chosen to provide a TFN (often due to age or language barriers) and the trust value is modest (the average value of trusts administered by State Trustees being around $60,000) the additional cost of compliance in addition to the amount of tax required to be withheld seems disproportionate to the income earned by the trust.

At present withholding must take place at the highest marginal tax rate (plus Medicare Levy) if the trust income is more than $120 per annum.

The administrative cost to the trustee (which is then funded out of the trust income) of compliance at such a low threshold in addition to the withholding and remittance of tax at top marginal rate (plus Medicare Levy) means that the beneficiary, in such circumstances, can be left with no distributable trust income whatsoever (in fact, the cost of compliance may exceed the remaining income, after withholding is taken into account).

State Trustees would support the introduction of a higher threshold for withholding in closely held trusts or assessment of the trustee at the appropriate rate of tax that would apply to the income if no beneficiary were "presently entitled" to it.

5 Other Issues with the operation of the trust income tax provisions

The Consultation Paper discussion at **5.1** of "fixed trust" provisions is important to State Trustees' administration of the majority of its trusts. However, there are many cases of trusts we administer which do not have beneficiaries with "vested and indefeasible interests" in the income or capital of the trust. Often, this position is determined by a single expression (or lack thereof) in the wording of a will or trust deed written at a time when the future taxation impact could not have been foreseen.

It appears inefficient to require the exercise of discretion by the Commissioner or the trustee to self-assess in each case without sufficient legislative structure to ensure the concessions available to "fixed trusts" can be accessed where appropriate.

State Trustees supports the recommendation that a review of the "fixed-trust" rules be undertaken.

6 Possible approaches to reforming Division 6

At **6.2** the Consultation Paper considers the possibility of categorizing trusts and creating a separate taxation regimen for each category, or developing a more "robust to variety" model.

Given the already discussed issue of the "fixed trust" definition alone, State Trustees favours the adoption of a "robust to variety" model which embodies the broad policy framework described at **6.1** and which is reflected in the TAD Model discussed in "Options for Reforming the Taxation of Trust income" at **8** in the Consultation Paper .

Though the clauses of a trust deed are critical to the trustee's task of administering the trust in the best interests of the beneficiaries State Trustees agrees with the statement at **6.3** that the tax system could focus assessment of income against those

beneficiaries who receive the economic benefits from the trust (and, conversely, assessment of the trustee where no beneficiary receives the benefit in relation to that income in a given year).

State Trustees does not support the introduction of legislatively defined additional tax components of trust income or "classes" of taxable income considered at **6.4.1**. Our concern with this concept resides in the likelihood that such classes would not align with existing trust instruments, and that the cost of implementation of such classes in trust accounting systems would be prohibitive.

At **6.4.2** the Consultation Paper raises the prospect that a "quantum approach" might result in increased trustee assessments. State Trustees favours a system of taxation of trust income based on a "quantum approach" as in the TAD Model. Should a trustee assessment result from the operation of such a model it would seem to be appropriate in the cases of the types of trusts State Trustees most frequently administers.

6.4.3 of the Consultation Paper then goes on to discuss the impact of the rate of tax applied to unallocated or retained amounts and subject to trustee assessment. The present tax law applies different rates of tax to retained amounts in different types of trust depending largely on how the trust came about.

While supporting a "robust to variety" approach to the method of assessing trust income for tax, State Trustees favours the retention of the present system whereby different rates of tax are applied to trustee assessments depending upon the origin of the trust.

7 Changes to improve the operation of Division 6

7.1 of the Consultation Paper discusses methods by which the scope of Division 6 might be better defined so as to determine if certain trusts are recognised for tax purposes under this Division. State Trustees favours the adoption of a robust "principle approach" rather than a "list approach", whether by inclusion or exclusion, to determine which trusts should be subject to Division 6.

7.2 of the Consultation Paper looks further at the issue of the timeframe for trustees' determination of entitlements. State Trustees' position on this is set out in our comments on **3.4** above.

In relation to the character retention by income and streaming discussed at **7.3**, State Trustees agrees that the ability to categorise and stream income should foremost be based on the words in the trust deed. Where the deed does not provide, then streaming should not be allowed and the character of income should be retained in accordance with general accounting principles. Any associated amounts, such as franking credits, should follow the income (dividends) in relation to which they arise.

7.4 of the Consultation Paper discusses the issue of the timeframes for amendments resulting in trustee assessment. Though the creation of a finite period for assessment of four years after the year of income is an improvement on the current indefinite arrangement, State Trustees is concerned that even this period creates complications in the finalization of trust matters. We favour an ability for a trustee to achieve a definite assessment or "clearance" as covered in our discussion of **3.6** above.

State Trustees supports the "maintenance of the status quo" discussed at **7.5** in relation to the fair and reasonable basis currently used by trustees to apportion expenses against beneficiaries and classes of income, which includes reference to any powers provided in the trust deed.

8 Options for reforming the taxation of trust income

It is broadly discussed throughout the Consultation Paper that the current operation of Division 6 and the proportionate approach to the assessment of trust income for tax purposes contains complexity and uncertainty that might only be further complicated by amendments that attempt to address specific issues within the current legislation. The potential for such an approach to inadvertently introduce (or at least fail to reduce) complexity and compliance costs is a concern.

Of the three models proposed at **8.1** to **8.3**, State Trustees believes that, although the "Patch Model" discussed at **8.1** may be the least intrusive of the three options to the existing current operation of Division 6, the TAD Model discussed at **8.3** has the greatest potential to provide simplicity and clarity to the assessment of the taxable income of a trust.

Although this may result in additional trustee assessments, this should only occur where, by "following the money", this would appear to be appropriate.

D. Questions for Consultation

At page 43 of the Consultation Paper 16 specific questions are posed. State Trustees comments are included below.

Question 1	**Do the policy principles outlined in Chapter 1 accurately reflect the existing framework for the taxation of trusts?**
	Yes
Question 2:	**The Government has identified a number of areas of the trust income tax provisions that require immediate reform. Are these the areas in most need of immediate reform? If not, what areas should the Government seek to reform as a priority?**
	The areas identified appear to be those most in need of reform. State Trustees has touched on others in this submission (i.e. the CGT treatment of corpus distributions and the franking credit rules and the need for family trust elections).
Question 3:	**Should the trust income tax provisions be updated and rewritten as part of a single process or would it be more appropriate to conduct this reform through a staged approach?**
	There are many issues identified in the Consultation Paper requiring attention in order to achieve the objectives of the review. Although the option for a single update addressing all concerns seems attractive there are significant and urgent issues requiring attention. To achieve a robust single reform on all issues may require a significant timeframe. It may not be practical to introduce reforms via a prioritised and staged approach.
Question 4:	**Uncertainty about the scope of Division 6 is arguably one of the key issues hampering the effective taxation of trust income. If the scope of Division 6 is clarified, under either an inclusion or exclusion approach, should a general principle or a comprehensive list be adopted?**
	The introduction of an improved means of identifying which trusts are subject to Division 6 will be of assistance. Without the benefit of being able to review the intended form of a comprehensive list State Trustees would favour a sound general-principle approach.
Question 5	**What types of trust might it be appropriate to carve out of the operation of Division 6? Are there any other areas of the tax law where a similar carve out for these types of trust may or may not be appropriate?**
	If possible, State Trustees favours an approach whereby all trusts are appropriately dealt with under Division 6.

Question 6:	**Is there sufficient uncertainty with the current treatment of expenses to warrant a legislative solution?**
	No – The trustee should continue to record and characterise expenses according to the deed and the relevant circumstances, and on a fair and reasonable basis.
Question 7:	**If the concept of distributable income is to be defined using tax concepts, what adjustment will need to be made to existing tax concepts to allow for a workable definition?**
	Tax concepts would need to be adjusted to recognise that a beneficiary's "share" of trust income, if any, does not simply arise based on a fraction or percentage of the whole of the trust income and its various components in all cases. The quantum a beneficiary is able to benefit from, and its specific income components (as arising from the operation of the trust deed and trust principles), should be capable of being recognised as the distributable income of the trust for tax purposes.
Question 8	**Should character flow-through and 'streaming' be provided on a general basis with specific limitations or alternatively through the use of specific provisions? If 'streaming' is provided using specific provisions, in addition to capital gains and franked distributions what other types of income should be afforded this treatment?**
	State Trustees believes character flow through and 'streaming' should be recognised on a general basis. Trustees should be in a position to follow the terms and provisions of the governing will or trust instrument.
Question 9:	**How should losses be dealt with where character flow-through of different classes of income is recognised?**
	State Trustees has no fixed view on this issue but reiterates its preference that it may be appropriate to align the treatment of trust losses with any reforms for company losses which may arise from with the Business Tax Working Group.
Question 10:	**In addition to those areas of the tax law highlighted in Chapter 4, are there any other areas that may need to be updated if changes are made to the current operation of Division 6?**
	None we can identify at this time.
Question 11	**Are there issues with the operation of the provisions highlighted in Chapter 4 that may need to be addressed, in addition to any changes that may need to be made to ensure that these provisions are able to operate effectively with an updated version of Division 6?**
	We refer to our submission and in particular to our comments on the various parts in Chapter 4.

Question 12	**Should there be one generic or multiple targeted tax regimes for the taxation of trust income? If a generic regime is desirable, which of the three approaches outlined in Chapter 8 should be adopted? Are there any other models that could be considered in updating the operation of Division 6?**

State Trustees favours a generic approach to the taxation of trust income. The TAD Model appears to us to hold the most promise to achieve the objectives of the proposed reforms.

Question 13:	**If a 'proportionate within class' model was adopted would it be necessary to define the concept of distributable income in the same ways as outlined under the 'patch' model?**

Yes.

Question 14:	**As highlighted in Chapter 8 the adoption of a TAD model may result in increased trustee assessments. If a TAD model was adopted is there an appropriate way to reduce the potential effects of the top marginal tax rate applying to unallocated amounts?**

The current operation of Division 6 in conjunction with the *Income Tax Rates Act 1986* (Cth) results in different marginal rates being applied to trustee assessments of trusts arising in different circumstances. State Trustees favours retention of this as a continuing principle of the fair taxation of trusts.

Question 15	**If a TAD model was adopted, how should the tax law define the concept of a 'distribution'?**

Regardless of the model or amendments created, it seems critical to establish a consistent definition of distribution across all tax law. We note that the definition provided in the recent legislative changes for Closely Held Trusts and beneficiary TFN withholding describes a distribution as being income amounts that are:

- paid to a beneficiary;
- paid for a beneficiary's benefit or needs; or
- allocated to a beneficiary (regardless of whether payment from the trust has taken place or whether the beneficiary has an interest in possession).

The "distribution" should be the quantum of the above income amounts in their respective components as accounted by the trustee using the provisions of the trust deed and accounting principles.

Question 16:	**If significant changes are made to the current operation of Division 6 what transitional measures do you consider the Government may need to provide?**

State Trustees has no firm view on this. Potentially trustees of trusts established prior to changes to the operation of Division 6 should have the option to elect to be have the trust's income assessed under the old or the new provisions.

E. Appendix

Further Background to State Trustees

State Trustees has been providing estate planning and administration services for Victorians for over 70 years. It began its existence in 1940 as the Public Trustee for Victoria.

It is now a public company under the Corporations Act, having become an authorised trustee company and Victoria's first State owned company in 1994. The State of Victoria, through the Victorian Treasurer, is State Trustees' sole shareholder.

State Trustees provides a range of services, including administration, estate management and trustee services, to individuals, charities, and government and corporate entities:

1. We presently administer around 2,500 deceased estates, and more than 3,000 trusts on behalf of around 10,000 beneficiaries. The trusts arise from estates, compensation payments, private settlements, court orders and other circumstances.

2. State Trustees acts under appointment by the Victorian Civil and Administrative Tribunal (**VCAT**) as administrator of the financial and legal affairs of approximately 9,000 'represented persons' (that is, persons found by VCAT to have a disability that impairs their ability to make reasonable financial decisions). It has also been engaged by VCAT to examine the accounts of private administrators.

3. We act for members of the public as their appointed attorney under enduring powers of attorney (financial). We are currently administering the affairs of over 700 Victorians who have appointed State Trustees as their attorney under enduring power of attorney (financial).

4. As a provider of estate planning and taxation services to the public, we advise people on the appropriate use of enduring powers of attorney (financial), and other enduring powers, as part of their overall estate planning arrangements or to meet particular immediate needs, and we also prepare enduring powers for members of the general public as part of that service.

5. In our role as either attorney or administrator, we may be required to take legal action for the recovery of monies or property misappropriated from a vulnerable individual by a third party, such as an attorney acting under a general power of attorney or an enduring power of attorney (financial).

6. We provide Community Services, including acting for individuals as their administrator or attorney under power of attorney, under an agreement with the Victorian Minister for Community Affairs.

7. As well as being an authorised trustee company, State Trustees holds an Australian Financial Services Licence (AFSL) covering a range of financial services and products.