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Dear Mr McCullough

Improving the Taxation of Trust Income

Thank you for your invitation to provide submissions on the legislative design of the proposed changes to the taxation of taxable income derived by a trust.

The Business Law Committee of the Law Society of New South Wales has considered the options for reform canvassed in the Discussion Paper, and the Committee's detailed comments are enclosed.

Should you have any questions, please do not hesitate to contact Ms Lana Nadj, Policy Lawyer for the Business Law Committee, by phone on (02) 9926 0375 or by email to lana.nadj@lawsociety.com.au.

Yours sincerely

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Improving the Taxation of Trust Income

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A. DEFINITIONS

In this submission:

(a) '**Committee**' means the Business Law Committee of the Law Society of New South Wales;

(b) '**Commissioner**' means the Commissioner of Taxation;

(c) '**defining distributable income using tax concepts**' means the approach outlined in Option 1 of the Discussion Paper, whereby the concept of "income of the trust estate" would be equated with "net income of a trust estate" in section 95 of the ITAA36, with adjustments to exclude notional amounts such as the gross up for franking credits.

(d) '**defining distributable income using accounting concepts**' means the approach outlined in Option 2 of the Discussion Paper, whereby the concept of "income of the trust estate" would be equated with a trust's accounting profit for the relevant income year, as determined by generally accepted accounting principles;

(e) '**defining distributable income to specifically include capital gains**' means the approach outlined in Option 3 of the Discussion Paper, whereby the trust deed is allowed to determine what constitutes distributable income for tax purposes, as is currently the case, but provided the trust's deed also includes any capital gains made by the trust in its distributable income;

(f) '**distributable income'** means the concept of '**income of the trust estate**' under section 95 of the *Income Tax Assessment Act 1936* (Cth);

(g) '**ITAA36**' means the *Income Tax Assessment Act 1936* (Cth);

(h) '**ITAA97**' means the *Income Tax Assessment Act 1997* (Cth);

(i) '**net income**' means "net income" as defined by subsection 95(1) of the ITAA36; and

(j) '**trust income**' means the income of a trust as determined under the trust deed and trust law.

B. EXECUTIVE SUMMARY

In summary, the Committee advocates that:

(a) The alignment of the definition of distributable income with net income (which is the aim of the proposed interim measures) should not be pursued. Instead an alternative method of taxation based on beneficiaries' trust income entitlements should be adopted.[1]

(b) If the Government continues with its proposal to align the definition of distributable income with net income, then trustees should be given the option to elect to determine matters based upon the terms of the relevant trust deed, the current definition of distributable income in section 95 of the ITAA36 or to adopt Option 1 or Option 3 proposed by the Government.

(c) Where a trustee chooses to adopt a new definition of distributable income, there should be a legislative provision drafted to ensure that any trust deed amendments made to facilitate this choice do not trigger a resettlement under the Federal income tax law. There should also be liaison with State and Territory governments to ensure that such trust deed amendments are not regarded as resettlements that trigger stamp duty.

(d) Trustees should be given more time to ensure beneficiaries are presently entitled to trust income than the current legislative deadline of 30 June in a financial year. This is particularly so for the 2010/2011 income year if a new definition of distributable income is enacted into law. In the latter case, additional time would provide trustees with an opportunity to seek advice on the impact of the new definition on their trusts and to determine whether trust deed amendments are required. The Committee suggests that trustees should be afforded 3 months from the end of the financial year within which to determine a beneficiary's present entitlement to trust income.

(e) The proposal to define distributable income according to accounting concepts (Option 2) should not be adopted as an interim measure.

(f) The interim measures proposed by the Government do not deal with all the problems affecting the taxation of trusts and should be expressly recognised as temporary measures. If they are adopted it follows that Treasury should commit to a fixed timetable for undertaking a detailed reform of trust taxation.

(g) A general 'streaming' rule that allows all types of income and tax attributes to flow through a trust should be enacted into the tax law, as distinct from a rule which would confine streaming to franked dividends and capital gains.

(h) The proposed income streaming amendments should be retrospective such that the Commissioner cannot amend prior assessments on the basis that income streaming is not available.

(i) The concept of a 'fixed trust' in tax law (particularly for the purposes of the imputation provisions and trust losses) should be reformed so that trusts which are in practice considered fixed trusts can meet the definition and pass on the benefit of franking credits and other tax attributes to beneficiaries and utilise prior year losses.

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[1] This alternative method is discussed on page 6 of this submission.

(j) Loss trusts should be provided with an option to pass through the benefit of franking credits (as currently provided to corporate tax entities).

(k) In situations where a beneficiary faces the prospect of being assessed on a capital gain to which they are not entitled, then the trustee should be provided with a choice as to whether it is the trustee or a beneficiary (or beneficiaries), in each case as determined by the trustee, who should bear this tax. The tax rate applicable in this circumstance should be an appropriate rate which reflects who will benefit from the capital gain, rather than the penal rate under section 99A of the ITAA36.

1. The Alignment Approach

1.1 Analysis of the alignment approach

1.1.1 The Discussion Paper indicates that the Government has decided to amend the law to better align the key concept of 'income of the trust estate' in section 97 of the ITAA36 so as to, firstly, reduce the incidence of anomalous situations where a beneficiary is taxed on more than they are entitled to under the trust, and secondly, to reduce or eliminate opportunities to manipulate tax liabilities.

1.1.2 For the reasons set out in paragraphs 1.1.3 to 1.1.8, below, it is submitted that to adopt the alignment approach is merely to adopt a 'band aid' solution to the problems which beset taxation under section 97 of the ITAA36. Taken at its highest, the approach is only directed to the problem of capital gains being taxed unfairly to an income beneficiary and to address itself to a perceived view that a trustee's reclassification power can be used to inappropriately avoid tax. As such, the measures associated with this approach should be regarded as temporary and, if adopted, should be overtaken by a more thorough redesign of the law on the taxation of trusts. A timetable for such a redesign should be set so that it does not become a proposal which is lost with the passage of time.

1.1.3 The alignment approach does not address all the difficulties that arise under the current taxation of trusts where trust income (as determined by the trust deed and trust law) differs from the trust's net income. Capital gains are just one example where trust income may differ from the trust's net income. Other examples where differences can occur include situations where:

i) a loss or expense is not deductible for tax purposes, but is deductible for trust accounting purposes. For example, a trust may not be able to satisfy the trust loss tests. Non-deductible entertainment expenses also fall into this category.

ii) a loss or expense is deductible for tax purposes, but not deductible for trust purposes. Depreciation is a good example of this type of loss.

iii) timing differences between when an expense is recognised for accounting purposes and when it is recognised for tax purposes. Employee leave provisions are a common example where timing can cause a difference between the trust income and its net income.

1.1.4 Where trust income is less than the trust's net income, the proportionate approach, as endorsed by the High Court in *Federal Commissioner of Taxation v Bamford* (2010) 240 CLR 481 (*'Bamford')*applied to a beneficiary under section 97 of the ITAA36 operates unfairly. A trust beneficiary is liable to pay tax on an amount which is more than they are actually entitled to receive from the trust.

1.1.5 The proposal to align distributable income using tax concepts does not resolve this issue as it is a question of a beneficiary's entitlement as determined by the trust deed and trust law, and not one of tax law per se. This unfairness has been highlighted by a number of judicial officers over the years.[2]

1.1.6 Where trust income exceeds the trust's net income then such unfairness does not arise. However, there is still uncertainty under the tax law as to how the excess trust income is taxed. Read literally, section 99B of the ITAA36 allows excess trust income to be taxed to the recipient beneficiary, as none of the exceptions in subsection 99B(2) of the ITAA36 apply to excess trust income.

1.1.7 The Commissioner has an administrative practice of choosing not to apply section 99B to tax a beneficiary of an Australian resident trust on such an excess. Presumably this is based on the suggestions made by Justice Hill in obiter, in *Traknew Holdings Pty Ltd v Federal Commissioner of Taxation* (1991) 21 ATR 1478. In that case, Justice Hill expressed the view that section 99B is aimed at taxing accumulations in foreign resident trusts and not Australian resident trusts. There is also uncertainty as to whether such an excess may be assessed under the ordinary income provision in section 6-5 of the ITAA97.[3]

1.1.8 It is unsatisfactory that there is still uncertainty as to how this excess is to be taxed and it is submitted that any revision of the trust taxation statutory provisions should expressly outline that distributions of excess trust income will not be taxed under the income tax provisions, and instead will be dealt with only under the capital gains tax provisions via CGT event E4.[4]

1.2 Assessment of the Three Options

1.2.1 *Option 1 – Defining distributable income using tax concepts*

i) The main advantage of this approach is that it does deal with capital gains so that income beneficiaries are not inappropriately taxed on gains to which they are not entitled. Nor it does reduce opportunities for tax avoidance. However, the approach does raise difficulties as to whether notional amounts should be included in assessable income. This issue of notional amounts is explored in paragraphs 3.2.1 to 3.2.13, below.

ii) Option 1 fails to resolve the problem of a beneficiary being subject to tax under the proportionate approach on more income than that to which they are entitled under the trust.

1.2.2 *Option 2 – Defining distributable income using accounting concepts*

The Committee strongly recommends Option 2 should not be adopted. This is because:

i) accounting standards can often be vague and difficult to interpret and apply, and they may also change in accordance with pronouncements by an unelected body;

ii) as acknowledged by the Discussion Paper there still remains a possibility that there will be differences between the concept of distributable income and taxable income since the accounting standards do not exactly correlate with the calculation of taxable income;

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[2] See Sunberg J in *Zeta Force Pty Ltd v FCT* (1998) 39 ATR 277 at 286 and Merkel J in *Richardson v FCT* (1997) 37 ATR 452 at 460.

[3] *FCT v Tindal* (1946) 72 CLR 608.

[4] Section 104-70, ITAA97.

iii) the accounting standards may not correlate with a beneficiary's entitlements under trust law (which is the aim of the proposed alignment approach). This is because a beneficiary's entitlement under trust law may be affected by the fiduciary obligations that a trustee has in respect of all trust beneficiaries. For instance, a trustee may decide not to recoup trust losses against income where the interests of beneficiaries in trust income and capital are co-extensive,[5] however, the accounting standards may still require such losses to be recouped;

iv) equating the concept of distributable income with accounting standards would further complicate the taxation of trusts since a trustee would need to take an additional step of ascertaining the trust's accounting income for the relevant year and then correlating it with the beneficiary's trust entitlements (which would be determined by the trust deed and trust law); and

v) significantly, trusts are used extensively by private small and medium enterprises and individuals. None of these entities are reporting entities for accounting standards purposes and to impose taxation based on income calculated under the accounting standards would add a significant cost burden to such entities, which they may not be able to meet given their small size.

1.2.3 *Option 3 – Defining distributable income to specifically include capital gains*

i) The more prescriptive Option 1, whereby distributable income would be defined according to tax concepts, may raise more anomalies and difficulties than this approach.

ii) However, since this approach only deals with one situation, namely where trust income may differ from net income of a trust, the taxation of trusts will still be problematic in relation to other examples where these income concepts differ.

iii) Significantly, including capital gains in distributable income does not solve the problem of a beneficiary being subject to tax on a capital gain to which they are not entitled. The Committee notes that the income beneficiary in Example 3 of the Discussion Paper is only 'saved' from being taxed on the capital gain included in distributable income, because Nerissa is entitled to the capital gain. In such a situation, it would be more appropriate for the trustee of the trust to be given a choice as to whether to be taxed on the capital gain, as indicated in paragraphs 3.7.1 to 3.7.3, below.

iv) The Committee submits that there is no need for a specific anti-avoidance rule to be introduced into the law should Option 3 be adopted, since Part IVA of the ITAA36 should be robust enough to deal with inappropriate reclassifications of income and capital by a trustee.

v) Option 3 also fails to resolve the problem of a beneficiary being subject to tax, under the proportionate approach, on more income than that to which they are entitled under the trust.

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[5] As per the High Court's reasoning in *Raftland Pty Ltd as trustee of the Raftland Trust v FCT* [2008] HCA 21.

1.3 An alternative approach

1.3.1 The Committee suggests that the Government consider an alternative approach which involves assessing beneficiaries on their proportionate entitlement (as determined pursuant to the trust deed and the trustee's exercise of their income distribution powers) to net income of the trust during the financial year. However, if there is a situation where a beneficiary may become subject to tax on more taxable income than that to which they are entitled under the trust, the trustee should be able to elect to be taxed on the difference in place of the beneficiary.

1.3.2 The tax rate which applies to the trustee where such an election is made should not be the penal rate under section 99A of the ITAA36. Rather, the trustee should be permitted to adopt the tax characteristics of the beneficiary who is considered to be presently entitled to the net income. That is:

i) the trustee would be taxed at the marginal tax rate which applies to the presently entitled beneficiary;

ii) in the event the trustee does not have the abovementioned information then the top marginal tax rate should apply; and

iii) the trustee should be able to claim the same tax concessions as the beneficiary. (For example, if the beneficiary is an individual then the trustee should be entitled to claim the CGT discount in respect of any capital gain that is in the trustee's assessable income.)

1.3.3 The penal tax rate under section 99A of the ITAA36 should not apply to tax a trustee in this circumstance. This is because if a beneficiary in this situation is taxed on net income which exceeds their entitlement under the trust, an accumulation of income is not involved. Instead, it is a difference between trust income and net income which generates this result.

1.3.4 In essence the alternative approach adopts a hybrid quantum approach[6] to the taxation of trust beneficiaries. It allows trustees to determine, in accordance with their fiduciary duties, whether taxation should occur at the level of the trust, or the beneficiary level.

1.4. Recommendations if the alignment approach is adopted

1.4.1 Where the Government chooses to pursue the alignment approach then the Committee suggests that trustees be given the ability to elect whether they wish to determine matters based upon the terms of the relevant trust deed, the current definition of distributable income in section 95 of the ITAA36 or to adopt Option 1 or Option 3 proposed by the Government.

1.4.2 The reasons for this are as follows:

i) due to the short time-frame for consultation it is not possible to assess all the advantages, disadvantages and implications that a new definition of distributable income may have on the many different types of trusts in the market place. The current definition of distributable income may operate appropriately for a particular trust with no revenue leakage to the Australian Taxation Office (ATO) but the new definition of distributable income may not operate appropriately in respect to such a trust;

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[6] The quantum approach was suggested by Merkel J in Merkel J in *Richardson v FCT* (1997) 37 ATR 452.

ii) in the aftermath of *Bamford,* many trustees have already expended costs in having their trust deeds reviewed and amended to enable them to continue to manage the trust in the best interests of beneficiaries. When a new definition of distributable income is enacted, such trustees will incur new, additional costs in ensuring that their trust deeds deal appropriately with the new definition of distributable income. For instance, some trust deeds may not allow a beneficiary to receive distributions of capital gains until a set time. Such deeds may need to be amended so that the trustee does not become subject to tax on the capital gain under section 99A of the ITAA36. The funds used to pay such costs could be used by trustees more productively to benefit beneficiaries and the economy more widely through their availability for business investment and other socially useful measures;

iii) the immediacy with which the Government proposes to implement the interim measures (that is, to apply in the 2010/2011 income year) may not provide trustees with enough time to fully assess the implications of any new distributable income definition for their trust and trust beneficiaries, nor to implement strategies (which may include trust deed amendments) to deal with the new definition appropriately;

iv) the concern as to the manipulation of tax liabilities expressed in Examples 2 and 4 of the Discussion Paper can be dealt with under the general anti-avoidance rule in Part IVA of the ITAA36. It is submitted that a reasonable taxpayer who is reliably informed of the tax laws would not enter into the schemes outlined in Examples 2 and 4. Certainly no qualified tax adviser would suggest such schemes.

1.4.3 The Government should also enact an express legislative provision to provide that any trust deed amendments which are made as a consequence of the proposed interim measures will not cause a resettlement of the trust for income tax purposes and in particular will not trigger CGT events A1 or E1. This is due to uncertainty in the law on the question of what constitutes a resettlement. It is noted that the Commissioner in his Statement of Principles adopts a narrower view of the law than recent case law on the subject (see for example *Federal Commissioner of Taxation v Clark* [2011] FAFC 5[7]).

1.4.4 The Federal Government should also enter into discussions with State and Territory governments so that such trust deed amendments are also not considered to trigger resettlements for stamp duty purposes.

1.4.5 It would be unfair for a change in Federal tax law to trigger significant additional tax costs which were not foreseen when the trust was established.

1.4.6 Trustees should also be provided with more time in which to make beneficiaries presently entitled to trust income than the current 30 June deadline provides. Additional time would enable trustees to seek advice on the implications that any new definition of distributable income will have for their trust, and to implement any required changes (whether this involve trust deed amendments or changes in relation to the trustee income distribution resolutions). The issue of timing is more fully addressed in the answer to Question 3 posed in the Discussion Paper, in paragraphs 3.3.1 – 3.3.5 of this submission.

[7] It is noted that the Commissioner has sought special leave to appeal this case in the High Court.

2. The Streaming of Franked Distributions and Net Capital Gains

2.1 Arguments for a general streaming rule

2.1.1 The proposal to amend the tax law to clarify that streaming of franked distributions and capital gains is permitted is to be commended.

2.1.2 Given that the structure of trust taxation in Australia is that they be conduit, flow-through entities in respect of income derived, the Committee suggests that a general streaming rule be inserted into the tax law such that streaming is not limited to capital gains and franked dividends.

2.1.3 Such a streaming rule would provide that all kinds of income, deductions and offsets retain their source and character flowing through a trust. This rule should allow trustees to stream different types of income and tax attributes to different beneficiaries where permitted by the trust deed. Such a rule would reflect the way that trusts were taxed in practice prior to the issue of the Commissioner's Decision Impact Statement on *Bamford*. If such a streaming rule were introduced there would be no need to make piecemeal amendments in specific parts of the legislation (as is currently proposed) to clarify that streaming is possible.

2.1.4 A streaming rule would clarify the current uncertainty as to whether trusts are taxed as conduits. This uncertainty was raised by the Commissioner's assertion that the proportionate approach to trust taxation endorsed by *Bamford* means that no streaming is possible and, in turn, by the High Court's reasoning in *CPT Custodian Pty Ltd v Commissioner of State Revenue* [2005] HCA 53 ('*CPT Custodian*'). In CPT Custodian, the High Court suggested that beneficiaries of most trusts drafted in the modern style may only be entitled to an amorphous, net residual amount. Certain aspects of trust taxation implicitly assume that trusts are conduits and streaming is permitted. For instance, section 97 of the ITAA36 segregates trust income into assessable income, exempt income and Australian sourced income. The suggested conduit rule would provide clarity as to how this segregation works.

2.2 Timing of proposed streaming amendments

2.2.1 The amendments proposed by the Discussion Paper are proposed to apply from the 2010/2011 income year.

2.2.2 It is submitted that the income streaming amendments should apply retrospectively such that the Commissioner cannot amend a taxpayer's assessable income where there has been streaming of franking credits and capital gains in the past. This is because the Government has indicated that the proposed streaming amendments are meant to clarify that such streaming is possible.[8] It would be unjust were taxpayers to be deprived of these clarifications in respect of past streaming practices where these were consistent with both industry practice and the Commissioner's past administrative practice, prior to the release of his Decision Impact Statement on *Bamford*.

2.3 The concept of a "fixed trust" requires legislative change

2.3.1 In the recent decision in *Colonial First State Investments Ltd v Federal Commissioner of Taxation* [2011] FCA 16 ('*Colonial First State Investments Ltd*') Justice Stone suggested that a trust could not be a 'fixed trust' for the purposes of the trust loss and franking credit provisions, where there was a variation power which could be used to

[8] Pages 15 and 17, Discussion Paper.

affect beneficiaries' entitlements to the income and capital of the trust. In such a situation, Justice Stone ruled beneficiaries do not have a fixed entitlement to income and capital of the trust as required by the definition of a fixed trust in section 272-65 of Schedule 2F of the ITAA36.

2.3.2 The variation power in *Colonial First State Investments Ltd* was contained in subsection 601GC(1)(b) of the *Corporations Act 2001*. However, Justice Stone's reading of the fixed trust definition causes concerns for most modern standard 'fixed'[9] and unit trusts, since in the vast majority of cases, such trusts generally contain variation provisions which enable the amendment of income and capital entitlements. Such variation provisions are inserted as a matter of prudence to take into account changes in circumstances that may occur over the life of a trust.

2.3.3 If the Government's intention is that franking credits can be streamed to beneficiaries of standard 'fixed' trusts and unit trusts, then this definition will need to be modified. Such a modified definition should not rely on the notion of a fixed entitlement to income or capital, because since the High Court handed down its decision in *CPT Custodian*, uncertainty exists as to whether any standard unit trust could meet the definition. Instead, such a definition should be focused on whether beneficiaries have discretionary entitlements. There is precedent for this approach in Subdivision 126-G of the ITAA97 which provides a CGT rollover between trusts which are not considered to be discretionary.[10]

2.3.4 If there is no change to the 'fixed trust' definition in section 272-65 of Schedule 2F of the ITAA36 then trustees of unit trusts and trusts which generally would be considered fixed in the market place may need to apply to the Commissioner and ask that he exercise his discretion to treat a trust as a 'fixed trust' under subsection 272-5(3) of Schedule 2F of the ITAA36. This is an extremely inefficient use of resources, both for trustees and the Commissioner.

3. Responses to specific questions posed in the Discussion Paper

3.1 <u>Question One:</u> If income of the trust estate is defined according to tax concepts should the gross capital gain be included in income or only the net capital gain (after applying the discount)?

3.1.1 It is not clear what this question is asking, and the uncertainty may lie in the way the defining distributable income using tax concepts approach operates.

3.1.2 If this involves calculating the distributable income in the same way the net income of the trust would be calculated in accordance with tax law then it may not matter whether the gross capital gain amount is included in distributable income or only the net capital gain amount. This is because the gross capital gain amount would be reduced to equate to the net capital gain in any event, as one calculates the distributable income according to tax concepts. On the other hand, until draft legislation is considered it is not possible to say definitively whether or not it matters if the gross capital gain amount or the net capital gain amount is included in distributable income.

3.1.3 The following numerical example may be of some assistance:

A trust derives $50 rent income and a capital gain of $80 which is eligible for the CGT discount.

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[9] This term is used here in its general sense, and not as defined in section 272-65 of Schedule 2F of the ITAA36.

[10] section 126-230 of the ITAA97

The trust has a carried forward capital loss of $10.

The trust's net income would be:

	$
Capital Gain	80
Less Capital Loss	(10)
	70
CGT discount	(35)
Net Capital Gain	35
Rent	50
	$85

The trust's distributable income upon the basis of tax concepts in isolation would be same figure of $85 whether one started with the gross capital gain or the net capital gain.

3.1.4 If the question is asking whether distributable income according to tax concepts should only include the gross capital gain (that is, without any further tax adjustments) or the net capital gain after tax adjustments, then when only considering these two alternatives the Committee recommends that the latter approach be taken. This is because it reduces the difference between the concepts of distributable income on the one hand and net income on the other, a difference which causes difficulties under section 97 of the ITAA36. In turn, this is because where the gross capital gain is included in the definition of distributable income according to tax concepts (with no further adjustments) then it is likely that a situation may arise where trust income exceeds net income of the trust. As noted above, a question would then arise as to whether section 99B of the ITAA36 would apply to tax a recipient beneficiary on the receipt of the excess trust income. Respectfully, the Committee suggests that neither approach be adopted but rather, the alternative approach to taxing beneficiaries discussed above be adopted.

3.1.5 The Committee notes that the question appears to be linked to the suggestion on page 10 of the Discussion Paper that it may be possible to split the net and discount components of a capital gain. It is submitted that this comment appears confused. It is most unlikely that a trustee using their income distribution powers alone could allocate a net capital gain to one beneficiary and an amount sheltered by the CGT discount to another beneficiary. This is because the discount component of a capital gain arises purely via applying a mathematical percentage against a net capital gain, that is, after any capital losses (if any) have been applied against the trust's capital gain: see Step 3 in the method statement in subsection 102-5(1) of the ITAA97 and section 115-100 of the ITAA97. In such a case, the benefit of the CGT discount therefore follows the capital gain.

3.1.6 Amounts sheltered by a tax concession such as the CGT discount or depreciation may be distributed differentially amongst beneficiaries under an appropriate power of the trustee to distribute capital from the trust. For instance, consider the following example:

A trust derives a $100 capital gain and utilises the 50% CGT discount.

The trust deed defines trust income to be distributable income calculated according to tax concepts. Therefore trust income is $50.

Individual A is made presently entitled to all the trust income. Under section 115-215 of the ITAA97 Individual A's taxation would calculated in accordance with the table overleaf.

	$
Trust income	50
Gross up of Capital Gain (s115-215(3)(b) of the ITAA97)	100
Less CGT discount	(50)
	100
Less deduction under s115-215(6) of the ITAA97	(50)
Taxable Income	$50

Depending on the terms of the trust the $50 cash sheltered by the 50% CGT discount at the trust level, may be distributed by the trustee to other beneficiaries of the trust under its capital distribution powers.

3.1.7 As can be seen from the example set out above, the ability to distribute amounts sheltered by the CGT discount (and indeed any other amounts sheltered by a tax concession) depends on the terms of the trust deed.

3.2 <u>Question 2:</u> Should all notional amounts (e.g. receipts or expenses) be excluded from the definition of the distributable income based on the concept of taxable income, or are there some notional amounts that should be included?

Notional amounts

3.2.1 A trust's net taxable income may include notional receipts and expenses such as the following:

i) the gross up for franking credits;

ii) deemed dividends under Division 7A of the ITAA36;

iii) attributed amounts under the controlled foreign companies rules and the proposed foreign accumulation fund rules;

iv) the deemed market value rules under the capital gains tax and the value shifting rules which operate to deem a taxpayer to have received market value consideration;

v) depreciation and capital allowance amounts; and

vi) amounts which the Commissioner deems to be included in assessable income under Part IVA of the ITAA36 or the transfer pricing provisions.

3.2.2 Notional amounts pose two particular difficulties with respect to the taxation of trusts. Firstly, there is uncertainty in the law as to whether it is possible to make a beneficiary presently entitled to a notional amount for the purposes of section 97 of the ITAA36. Secondly, significant cash flow difficulties may arise where a notional amount is included in the definition of distributable income based on tax concepts.

Present entitlement to a notional amount?

3.2.3 For a beneficiary to be considered to be presently entitled to trust income:

i) their interest in trust income must be vested in interest and vested in possession; and

ii) they must have a present legal right to demand and receive payment of the income, whether or not the precise entitlement can be ascertained before the end of the relevant year of income and whether or not the trustee has the funds available for immediate payment: *Harmer v Federal Commissioner of Taxation* (1991) 173 CLR 264 at 271.

3.2.4 Since a notional amount is a fiction created by the tax law, it is difficult to see how there could be a present legal right to demand payment of such an amount from the trustee as at the end of the income year (as required by section 97 of the ITAA36). The issue of whether a beneficiary can be made presently entitled to a notional amount was queried by Justice Stone in *Colonial First State Investments*[11] (as noted on page 7 of Discussion Paper). However, the strength of Justice Stone's comment is unclear since there is no analysis included in her judgment to found her conclusion.

3.2.5 In *Thomas Nominees Pty Ltd v Thomas & Or* [2010] QSC 417 ('*Thomas Nominees'*) Justice Applegarth of the Queensland Supreme Court adopted the view that a notional amount (in particular, franking credits) could be included in a trust's distributable income and allocated amongst beneficiaries. This was because the trust deed expressly treated franking credits as a type of distributable income: see paragraph [35] of *Thomas Nominees*. Additionally, Justice Applegarth found it difficult to accept that franking credits were merely a notional concept of tax law which could not be dealt with by the trustee, because the franking credits have a real financial benefit.

3.2.6 To a limited degree the case of *Clark v Inglis* [2010] NSWCA 144 ('*Clark')* also provides support for the view that a beneficiary can be made presently entitled to a notional amount. In that case, the NSW Court of Appeal held that a beneficiary could be made presently entitled to unrealised gains made by a trust.

3.2.7 The High Court's decision in *Bamford* that the concept of 'income of the trust estate' can be determined by the trust deed arguably supports a view that a beneficiary can be made presently entitled to a notional amount, since the trust deed (as in the case of *Thomas Nominees*) can empower the trustee to include notional amounts in distributable income and to deal with such amounts in accordance with their trust powers.

3.2.8 It is important to note that both *Thomas Nominees* and *Clark* involve notional amounts where there was some substantial increase to the trust's capital value (being the benefit of franking credits or an unrealised gain).

3.2.9 There must be some doubt as to whether the courts would accept that a pure notional amount can be included in a trust's distributable income. It is noted that in *Clark* the NSW Court of Appeal traversed whether the practice of including unrealised gains in trust income was acceptable under accounting principles.

3.2.10 A current 'live' example of a notional amount where arguably there is no increase in a trust's capital, is deemed Division 7A dividend income arising from a Section Three loan which, the Commissioner suggests, can originate from an unpaid present entitlement owed by a trust to a corporate beneficiary.[12] The following diagram outlines how a deemed Division 7A dividend can arise from a Section Three loan:

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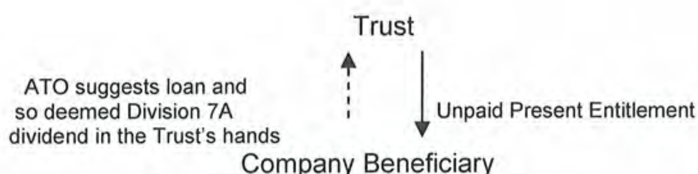
[11] At paragraph [88].

[12] Taxation Ruling TR 2010/3.



3.2.11 In the example, the trust's capital has not been increased in this situation because it still owes an unpaid present entitlement to the company beneficiary and has no entitlement to the unpaid present entitlement at law. The deemed Division 7A dividend (representing the amount of the unpaid present entitlement) which the Commissioner asserts arises in the trust's hands is a purely notional amount and it would be difficult to consider that it is income in the hands of the trust or any form of accretion to the trust estate.

3.2.12 Due to the uncertainty surrounding whether a beneficiary can be presently entitled to a notional amount, if a notional amount is to be included in the definition of distributable income based on tax concepts, then there should be an express provision in the tax law specifically enabling a beneficiary to be presently entitled to such a notional amount.

3.2.13 In such a situation a deemed present entitlement is required because if there is no such provision, a situation could arise where no beneficiary is considered to be presently entitled to such income, in which case the trustee would be taxed at the top marginal tax rate on that share of net income of the trust under section 99A of the ITAA36. An example of where this adverse taxation consequence has occurred can be found in ATO ID 2005/20 where the Commissioner ruled that beneficiaries could never be made presently entitled to foreign investment fund income and as a consequence the trustee was taxed on such income under section 99A of the ITAA36.

Cash flow problems

3.2.14 Significant cash flow difficulties may arise where notional amounts are included in the definition of distributable income for tax purposes.

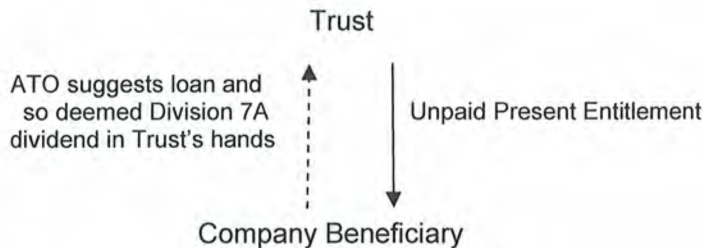
3.2.15 Since notional amounts are tax fictions, the trust will not have the cash to pay out the notional amounts to beneficiaries. For instance, if a trust derives a larger capital gain as a result of the market value deeming rule for capital proceeds operating to deem that the trustee has received more capital proceeds than actually received under the transaction, the trustee may not actually have the cash to pay out the larger 'notional' portion of the capital gain.

3.2.16 To ensure that this notional gain is not taxed unfavourably under section 99A of the ITAA36 the trustee may want to make a beneficiary presently entitled to the notional amount. Where this occurs the trustee would either have to borrow to pay out the beneficiary's entitlement or rely on the beneficiary's good graces not to call for payment of the amount.

3.2.17 These cash flow difficulties suggest that any definition of distributable income according to tax concepts should exclude some notional amounts which have the effect of increasing a trust's net taxable income such as, for example, the franking credit gross up.

3.2.18 However, not all notional amounts that increase a trust's net taxable income should be automatically excluded from the definition of distributable income according to tax concepts. This is because if they are not included in distributable income then a situation may arise where the trustee may be liable to pay tax on those notional amounts under section 99A of the ITAA36 because no beneficiary is presently entitled

to such an amount. For instance, consider the deemed Division 7A dividend in the diagram overleaf:



3.2.19 If distributable income does not include the Division 7A dividend, and the trust derives no other income in the income year, then a situation could arise where the trustee is taxed on the Division 7A dividend at the highest marginal tax rate under section 99A of the ITAA36. This appears to be an additional, excessive penalty. Any definition of distributable income according to tax concepts should allow the trustee to distribute the Division 7A dividend to a trust beneficiary and only suffer one tax penalty (namely the deemed Division 7A dividend).

3.2.20 Notional amounts which reduce a trust's net income (such as capital allowances) may be included in the definition of distributable income according to tax concepts since, firstly, they do not cause cash flow difficulties and, secondly, including such amounts in the definition would align it more closely with the net income concept.

3.2.21 Due to the short time for consultation it is not possible to provide a general rule of when notional amounts should be included or excluded from distributable income. It is suggested that the Government undertake a review and consideration of the effect of each type of notional amount possible under the tax law on distributable income, when formulating the distributable income definition.

3.2.22 A possible interim measure to deal with the short consultation period is to provide trustees with the option of choosing whether to include a notional amount in trust income. This would allow trustees to manage any unfairness that may arise where a notional amount is inadvertently included or excluded in the distributable income definition because of the short time frame for drafting such laws, when really the notional amount should otherwise have been dealt with.

3.3 <u>Question 3:</u> Would adjustments to the definition of distributable income also be needed where timing differences exist between distributable income (as newly defined) and the trustee's calculation of "income" pursuant to the terms of the trust? How could this be achieved?

3.3.1 Given that trust deeds vary in relation to when trust accounts may take place (particularly where a foreign trust is involved where the country has a different financial year from Australia) this issue of timing differences may never be completely resolved and it is probably not possible to adjust the definition of distributable income to remove such differences.

3.3.2 The extent to which timing differences arise between distributable income (as newly defined) and trust income will depend on the way that trust income is defined under the terms of the trust deed.

3.3.3 One timing issue which needs to be addressed is the requirement under section 97 of the ITAA36 that a beneficiary be presently entitled to 'income of the trust estate' by the end of the relevant income year. In practice this requirement is difficult to satisfy given that trust accounts are not completed until sometime after the end of the relevant

income year. Whilst in some circumstances it is possible for a trustee to anticipate income and make trustee income distribution resolutions by year end, in other cases it may be questioned whether a trustee is carrying out its trustee duties properly where it makes such resolutions prior to obtaining the accounts of the trust. The Commissioner has an administrative practice of generally allowing trustees 2 months after the end of the income year to make their income distribution resolutions. However, in many tax cases the Commissioner has refused to apply this administrative practice and instead has sought to apply the year end requirement as required by law.

3.3.4 It is suggested that trustees should be given more time to make their income distribution resolutions after year end, so that meaningful distribution resolutions can be made. It is noted that in the managed investment trust area, trustees are provided with 3 months after the end of the relevant income year to make fund payments so as to take advantage of the concessionary withholding tax rate. It is submitted that trustees of trusts in general should similarly be afforded an appropriate time after year end to make their income distribution resolutions.

3.3.5 Timing differences should not generally affect the total tax collected from a trust and its beneficiaries in the long run. However, in the short term it may lead to situations where a beneficiary is subject to Australian tax on trust income in one financial year which they are not entitled to receive until another financial year. This situation occurs most commonly where an Australian resident is a beneficiary of an overseas trust. Often besides this cash flow issue, additional compliance costs are incurred in generating 30 June year end accounts for the trust. The Commissioner has a discretion under section 18 of the ITAA36 to allow a trust to adopt a substituted accounting period. However, it is extremely rare for the Commissioner to exercise this discretion in respect of a trust. It is suggested that more guidance be provided in the legislation to allow the Commissioner to exercise his discretion to allow a trust to adopt a substituted accounting period. This should contemplate situations where a beneficiary is, through no fault of their own, subject to a situation where they are taxed on trust income earlier than they are entitled to receive it, such as in the case of an Australian resident beneficiary of a foreign trust that adopts a different financial year end which is in line with the foreign country's financial year end.

3.4 <u>Question 4:</u> Would the introduction of a specific anti-avoidance provision be effective to ensure that re-classification clauses could not be used to re-classify amounts of income or capital to obtain a tax benefit?

3.4.1 The introduction of a specific anti-avoidance provision to prevent inappropriate re-classifications of income and capital amounts is not needed, and would only serve to further complicate the law with no certainty of being effective. As already noted on page 12 of the Discussion Paper, introducing a specific anti-avoidance rule may lead to uncertainty and additional compliance costs for taxpayers in interpreting the application of such a rule.

3.4.2 The fiduciary duties that a trustee has in respect of its beneficiaries and the scope of the general anti-avoidance provisions in Part IVA of the ITAA36 are already effective enough to deal with manipulation concerns.

3.4.3 In *Forrest v Federal Commissioner of Taxation* [2010] FCAFC 6 the Full Federal Court confirmed that a trustee's power to reclassify income is not a completely discretionary power. Instead, this power is regulated by trust law and the trustee's fiduciary duty to ascertain the income and capital of the trust. The Court also ruled that the power could not be used by a trustee to deny a beneficiary's entitlements under the trust. Accordingly, it cannot be said that a trustee can use a reclassification power in any way

that it desires. The use of the power must be in furtherance of trust purposes and, subject to the terms of the trust, impartial amongst beneficiaries.

3.4.4 Even if reclassification is permitted for trust law purposes, if there are no reasonable non-tax related justifications for such an action then such a reclassification should be caught by Part IVA of the ITAA36. The examples given in the Discussion Paper where the reclassification power has been used to manipulate tax liabilities, that is, examples 2 and 4, involve circumstances where Part IVA would most likely apply. It is submitted that no reasonable taxpayer who is properly advised of the tax law would seek to undertake the reclassifications outlined in Examples 2 and 4, since the reclassifications set out in those examples are blatant tax avoidance schemes.

3.5 Question 5: Even if a specific anti-avoidance provision were introduced to restrict the reclassification of trust amounts, would the distributable income of a trust still need to include any capital gains made by the trust to ensure that income beneficiaries are not taxed on capital gains that only benefit capital beneficiaries?

3.5.1 If this question is suggesting that such a specific anti-avoidance provision will constrain a trustee's ability to reclassify trust amounts so that a capital gain may not be able to be included in the trust's distributable income, then the definition of distributable income should include capital gains (subject to the option in the hands of the trustee as previously submitted). The trustee should be provided with a choice as to whether or not to include capital gains in distributable income – the trustee may have other fiduciary duties to beneficiaries where inclusion of the capital gain in distributable income may not be in a beneficiary's best interests.

3.6 Question 6: Apart from clarifying the operation of subsection 207-35(3) of the ITAA97 (in particular the meaning of the words "despite Division 6") are other changes needed to ensure that Subdivision 207-B operates appropriately?

3.6.1 Reference to the way that Subdivision 207-B operates and interacts with Division 6 of the ITAA36 should be included in Division 6 of the ITAA36. This could be achieved by a way of a note to the section 95 definition of 'net income'.

3.6.2 Additionally it is submitted that Subdivision 207-B of the ITAA97 does not operate appropriately where a trust incurs a loss or nil trust income in the income year when franked dividend income is received by the trust. Under the current law where the trust's carry forward losses fully offset trust income, then the benefit of any franking credits attached to such dividends cannot be claimed by either a trust beneficiary or the trustee. This flows as a result of subsections 207-50(3)(c) and 207-50(4)(c) and Column 2, item 3 of the table in subsection 207-55(3) of the ITAA97.

3.6.3 For franking credits to flow to the beneficiary or trustee, the trust must have some positive trust income in the relevant income year. A loss trust is essentially a "dividend trap" and in effect the franking credit gross up which is required to be included in the trust's net income under section 207-35 of the ITAA97 inappropriately 'eats up' the benefit of the trust's prior year losses.

3.6.4 Corporate taxpayers with carry forward losses have been provided with a concession in section 36-17 of the ITAA97 which allows such taxpayers to choose not to offset their losses against taxable income, so that franking credits can be claimed and there is not wastage of losses via the franking credit gross up. This concession does not apply to trusts. It is submitted that trusts should be allowed to access this concession since it makes no sense to differentiate between trusts and corporate tax entities in this respect.

3.7 Question 7: Should Subdivision 115-C continue to apply after the application of Division 6 where there is a discrepancy between a beneficiary's entitlement to a capital gain included in the distributable income of the trust and the amount of the trust's net capital gain included in the beneficiary's assessable income?

3.7.1 The purpose of Subdivision 115-C of the ITAA97 is to allow capital gains to flow through the trust as through a conduit, such that a beneficiary can apply their capital losses to capital gains derived by the trust prior to certain concessions - such as the CGT discount and small business 50% reduction - being claimed.[13] Given the structure of Division 6 and the way that net capital gains are calculated under Part 3-1 of the ITAA97, the application of Subdivision 115-C of the ITAA97 after Division 6 of the ITAA36 appears to be appropriate.

3.7.2 However, where there is a discrepancy between a beneficiary's entitlement to a capital gain which forms part of the distributable income of the trust and the amount of net capital gain included in a beneficiary's assessable income, the trustee should be given a choice as to the tax treatment of this discrepancy. This choice would be a modification of what is already available to a trustee of a resident testamentary trust in section 115-230 of the ITAA97 (specifically, Subdivision 115-C of the ITAA97). Under section 115-230 of the ITAA97, where capital gains are included in the assessable income of a beneficiary who cannot benefit from them, the trustee has until 2 months after the end of the relevant income year to choose to be taxed on the beneficiary's share of the net capital gain instead of the beneficiary. The choice in section 115-230 of the ITAA97 provides trustees and beneficiaries with flexibility needed to deal with the cash flow issues arising where there is tax but no entitlement to the capital gain. The choice in section 115-230 of the ITAA97 is similar to an administrative concession the Commissioner provided to all trusts in Practice Statement PS LA 2005/1 (GA), which the Commissioner withdrew after the judgment was handed down in *Bamford*.

3.7.3 The unfortunate aspect of section 115-230 of the ITAA97 is that it is confined to resident testamentary trusts only. The taxation for the trustee on the net capital gain amount is determined under section 99A of the ITAA36. It is submitted that there is no rationale for confining section 115-230 of the ITAA97 to resident testamentary trusts. Additionally, the taxation to the trustee under section 99A is penal, being at the highest marginal tax rate, and will lead to the denial of the CGT discount and small business 50% reduction under section 115-225 of the ITAA97. It is submitted that in this unfortunate circumstance where a beneficiary is taxed on more income than that to which they are entitled under the trust, that if the trustee can choose to be taxed under section 115-230 of the ITAA97 there should be modifications so that the CGT discount and small business 50% reduction can be claimed, and a tax rate commensurate with the beneficiary's tax rate applied. This is because in such a circumstance there has been no inappropriate accumulation of the net capital gain to justify section 99A taxation but rather, what has occurred is that the capital gain has been inappropriately included in the beneficiary's assessable income.

3.8 Question 8: Instead of looking to amounts assessed to beneficiaries under Division 6, should Subdivision 115-C instead look to the trust entitlements of the beneficiaries?

3.8.1 Whilst ever the current method of trust taxation of beneficiaries under section 97 of the ITAA36 applies, Subdivision 115-C of the ITAA97 will need to take into account what is assessed to beneficiaries under Division 6. However, Subdivision 115-C should operate to tax beneficiaries according to their trust entitlements since it is inappropriate for a tax system to tax persons on amounts which they are not entitled to receive. If the current method of taxation under section 97 of the ITAA36 is maintained then the Committee's

[13] section 115-200 of the ITAA97

suggestion outlined in response to Question 7 above, that a modified version of section 115-230 of the ITAA97 apply to all types of trusts, should ameliorate this unfairness.