THE TAX INSTITUTE

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The Treasury
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Dear Mr Bradshaw

## Improving the taxation of trust income

The Tax Institute welcomes the opportunity to comment on the Treasury's "*Improving the taxation of trust income*" discussion paper (**Discussion Paper**) which was released on 4 March 2011.

We would like to thank the Treasury for convening the meeting in Canberra on 16 March 2011 for the various professional/industry bodies to express their preliminary views on the Discussion Paper. This written submission builds on the preliminary views that we expressed at that meeting.

A summary of our position is as follows:

- The government's intention of removing doubt around certain aspects of the operation of Division 6 is timely and responsive.
- We urge the government to implement an "interim solution" for the income year ending 30 June 2011. Our proposed interim solution is that the ATO's previous administrative practice, set out in the (now withdrawn) PS LA 2005/1 and TR 92/13, should be codified in the legislation.
- This will give trustees and their advisers certainty for the current income year. It is an approach that should be acceptable to tax practitioners, as they are familiar with the process contained in the practice statement and ruling. Applying an alternative approach would probably require trustees and their advisers to review their trust deed to ensure they comply with the amended law, and this would be an extremely difficult task given that we are working in a short time frame.
- Applying the ATO's previous administrative practice will mean that net capital gains that are included in the net income of a trust estate will be taxed to the appropriate beneficiary under either the proportionate approach, capital beneficiary approach or trustee approach (as outlined in the practice statement).
- We agree with the proposals for enabling the streaming of franked distributions and net capital gains. In addition, we suggest that the government consider legislatively acknowledging that the inclusion of notional amounts in taxable income does not give rise to present entitlement issues.

- We consider that Managed Investment Trusts (**MITs**) and similar "fixed" trusts should be excluded from any legislative changes relating to the definition of "net income" or "distributable income". However, MITs should be provided the certainty in respect of the streaming of tax attributes such as franking credits.

Our detailed submission, including our responses to the consultation questions outlined in the Discussion Paper, is attached.

If you require any further information or assistance in respect of our submission, please contact me on 02 8223 0011 or The Tax Institute's Tax Counsel, Tamera Lang, on 02 8223 0059.

Yours sincerely

Peter Murray
President

# Attachment
# Detailed submission

Terms not otherwise defined in this submission take their meaning from the terms defined in the Discussion Paper. All legislative references in this submission are to the *Income Tax Assessment Act 1936* (**ITAA 1936**) and the *Income Tax Assessment Act 1997* (**ITAA 1997**) unless otherwise stated.

## 1 Introductory remarks

The Tax Institute considers the government's intention of removing doubt around certain aspects of the operation of Division 6 to be timely and responsive.

We applaud the government's proposal to remove any doubt raised regarding the ability of a trustee to stream income of a particular character. In the Discussion Paper, it is proposed that the streaming of capital gains and dividend income be addressed. While we support such a proposal as completely appropriate, we believe that the changes should go much further and the law should confirm that streaming of income of different character types is possible – whether it be dividends from domestic sources or foreign or interest, rent or any other identifiable type of income. We believe that the same fundamental principles arise and can broadly be addressed in the same way.

After much reflection we are of the view that the proposal that seeks to better align distributable income with tax income suffers significant challenges. We consider that the suggested solutions each suffer from design problems that are likely to result in inappropriate taxation of the trustee at the highest marginal rate. Rather than "not seek to tax trusts as companies" (as the Assistant Treasurer said on 4 March 2011 at The Tax Institute's 26th National Convention), the proposals are likely to result in taxation at top marginal rates for a much larger proportion of income than is either appropriate or currently the case. We have set out some examples of why the models proposed in the Discussion Paper cause significant difficulties for many trusts.

It is The Tax Institute's belief that altering a key concept such as "net income" without broader reform of Division 6, could lead to undesirable and unintended consequences. Furthermore, it would be impossible for our members to review their clients' trust deeds and assess the possible impact of the new provisions (as well assess whether there would be adverse consequences of amending the trust deed to deal with the new provisions) prior to 30 June 2011.

All of the models in the discussion paper seek to align the distributable income with the taxable income, where many trust deeds craft distributable income in a way that does not equate to taxable income. The extent to which the mismatch between distributable income and taxable income adversely impacts on beneficiaries or poses a threat[1] to revenue depends on the type of trust involved.

We consider that there are three broad categories of trusts:

1. "Fixed trusts", being trusts where there are common capital/income entitlements and no differential classes of units.[2] The trust deeds of these funds are such that they cannot avail themselves to the type of mischief that appears of concern to the Treasury.

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1 We make no comment on whether such arrangements in fact represent a threat to the revenue; we state this only in the acknowledgement that the Treasury and ATO appear to be of the view that some arrangements pose a threat to the revenue.

2 We acknowledge that the technical definition of a "fixed" trust is unclear (refer to the recent *Colonial First State Investments Limited v Commissioner of Taxation* [2011] FCA 16). In this context, we only refer to "fixed" in the sense that the trustee does not have a discretion in respect of the allocation of income and capital as between beneficiaries.

In relation to "differential classes" we note that different classes based solely on differential fees between the classes should not, we submit, be treated as having differential classes of units for this purpose.

2. MITs, which may deliberately and legitimately work on a basis of cash distributable income that is quite different to taxable income (e.g. in the property sector, cash distributable income would usually exclude capital gains, as the proceeds from the sale of one property are reinvested in another). These entities are typically in the "fixed trust" category above.

3. Discretionary trusts, where there are discretionary and/or differential entitlements to income and capital. These trusts are the kind which face significant problems with the "net income" definition, and appear to be the target of Treasury's concerns.

The first and second categories (i.e. "fixed" trusts and MITs) should not be impacted by the solution that we are proposing (i.e. the "interim solution", set out in section 2 below). In fact, in the case of MITs, we suggest that they be excluded from the new regime altogether (refer to our analysis at section 6 below). It is the third category of discretionary trusts which are in need of legislative certainty for the income year ending on 30 June 2011.

## 2 Our proposed approach for discretionary trusts – the "interim solution"

As broader reform of Division 6 is not intended (and could not be achieved) prior to 30 June 2011, we propose that the Treasury implement an "interim solution". That is, PS LA 2005/1 and TR 92/13 should be legislatively restored and codified until such time that Division 6 is reformed.

This will mean that the past administrative practices of the ATO, which were in place prior to the *Bamford* decision, should be adopted. This should be acceptable to trustees and their advisers, as they understand the concepts and can apply them with reasonable confidence. It should be acceptable for the current year, provided it is accurately codified in the legislation.

## 3 Why the distributable income models in the Discussion Paper are unsatisfactory

### *3.1 Option 1 (defining distributable income using tax concepts)*

This option seeks to define distributable income using the tax definition of net income, adjusted by relevant amounts.

#### *3.1.1 Why this model is unsatisfactory*

We consider that the approach fails to appreciate that it is not a matter of "aligning" distributable or trust income and section 95 net income. There will be occasions, and they will be frequent, where the net income includes an amount – that is, a calculated or arithmetical amount, not an "amount of money" actually in existence as an asset – which simply does not and cannot exist. For example, an expense which is not deductible,[3] differences between tax and accounting depreciation rates, variances arising from the application of the market value substitution rules.

Capital gains are a different matter – they are surpluses (represented by part of the proceeds of realisation) which are received on capital account but taxed on revenue account. In those cases there is a good case for taxing them according to where the economic entitlement falls.

We consider that where the differences are not represented by assets – for example, the amounts in the *Bamford* case, Part IVA determinations and other permanent differences,– there is a policy decision to be made. That is, who should in such a case bear the tax? In the case of timing differences that arise from, for example, CFC/FAF, TOFA, depreciation differences, provisions and reserves, it is often the case that the net income reflects a current tax liability with deferral of the enjoyment of the cash, but the difference is actually represented by underlying assets. How this should be resolved in a policy sense requires greater reflection, and should be addressed as part of the broader reform of Division 6.

It has long been the basic premise that all trust section 95 net income should be brought to tax somewhere. The issue is: where nobody does, and nobody can, have enjoyment of the amount,

3 As was the case in the facts of the *Bamford* decision in the 2000 income year.

now or in the future (i.e. the permanent differences) who should pay the tax on what cannot be enjoyed? It is critical that this question be answered, before we attempt to reform who is taxed and how.

*3.1.2 Example*

The following example shows how defining distributable income using tax concepts can lead to anomalous results. In this example, there is a non-deductible expense of $20, being a repairs/maintenance expose that constitutes an improvement for tax purposes and thus is non-deductible as it is capital in nature.

| **Financial accounts** | **$** | |
|---|---|---|
| Franked dividends | 70 | |
| Franking credits | 30 | |
| Interest | 70 | |
| Notional assessable income | 50 | |
| Non-deductible expense e.g. | 20 | |
| Net income (per section 95) | 220 | |
| Distributable income (for trust purposes) | 120 | *(being 70 + 70 less 20)* |
| Distributable income (for tax purposes) [4] | 140 | |

*Position under current law*

The current position is that each beneficiary attributed 50% of section 95 net income, i.e. $110 each. We consider this to be an appropriate outcome.

*Alternative position, as proposed by the Discussion Paper*

Of the tax distributable income, the beneficiaries together are presently entitled to only $120 (being the trust distributable income). Thus, there is a balance of $20 (i.e. the balance of the tax distributable income) to which to which no beneficiary is presently entitled. In accordance with the proposal set out in the Discussion Paper, this amount would be taxed to the trustee.[5] We consider that it is inappropriate and undesirable for the trustee to be taxed in these circumstances.

### *3.2 Option 2 (defining distributable income using accounting concepts)*

This option seeks to define distributable income using generally accepted accounting principles. The problem with this model is that accounting principles frequently include amounts in income/profit that are effectively notional accounting amounts. There are variations and interpretations of how accounting standards apply in particular circumstances and some types of trusts are able to *not* apply certain accounting standards. Also, many closely held trusts will not apply generally accepted accounting principles, as they are not obliged to prepare financial statements (except to the extent to which they are obliged under a trust deed to prepare them, in which case they will be prepared in accordance with the dictates of the deed, which will not necessarily coincide with accounting concepts).

Also, adopting this approach would mean that beneficiaries may be entitled to amounts that have no basis in the trust deed, and thus may give rise to present entitlement issues.

4 It is assumed that the defined distributable income for tax purposes under the Discussion Paper would exclude notional amounts, including franking credits.

5 Refer to the analysis on page 9 of the Discussion Paper.

### *3.3 Option 3 (defining distributable income to specifically include capital gains)*

While this option is more targeted, it is only addressing the capital gains tax issue. Further, its starting point is taxable income, which will often be different to the concept of distributable income under the terms of the deed and accordingly, many of the differences that give rise to issues currently will not be resolved.

## 4 Dealing with streaming issues

We generally agree with the approach that is set out in Chapter 3 of the Discussion Paper.

### *4.1 Dealing with notional amounts*

We suggest that, for the avoidance of doubt, there should be a legislative acknowledgment that including notional amounts (such as franking credits) in notional income does not give rise to present entitlement issues.

As a practical matter some of the perceived difficulties of dealing with notional amounts may be dealt with by a simple drafting change to the definition of net income for the purposes of section 95 in the ITAA 1936. This would not require the establishment of a minimum distribution benchmark in order for the tax allocation to operate.

Many deeds simply adopt the concept of net income for the purposes of section 95 as a basis to determine the income of the trust - in some cases as a default position, or in some cases as the primary basis to determine the income of the trust. As a matter of drafting, if the notional amounts were never included in the net income for the purposes of section 95 but attached to the income allocated to the relevant beneficiary then these concerns should be dealt with. It would not alter the tax outcome for the beneficiary or the trust. However, the concerns about whether the distribution of notional amounts may be made will not arise for these trusts. They do not become part of the income of the trust for the purposes of the deed so it no longer necessary to consider how they can be allocated. The allocation occurs as a matter of law where the beneficiary becomes entitled to the relevant income.

This is a simple practical way of dealing with this issue for many trusts without requiring the deeds to be altered, without a wholesale review of trust deeds and without a cost for taxpayers.

### *4.2 Dealing with other tax attributes*

There are other types of tax attributes that should be allowed to stream through a trust, such as foreign income tax offsets, entrepreneurial tax offsets etc. We encourage Treasury to review the existing mechanisms in the ITAA 1997 to ensure that streaming and character flow-through of all special tax attributes can occur.

## 5 Specific anti-avoidance provision

The Tax Institute generally does not support the enactment of a specific anti-avoidance provision when there is a strong and effective general anti-avoidance rule in Part IVA. Nonetheless, an appropriately drafted positive integrity test could ameliorate the concern that manipulation could arise.

It may be desirable to require the economic benefits and taxable income of beneficiaries to be “consistent” (whilst recognising that they cannot be the same, as there will always be some differences).

## 6 Exclusion for MITs

We consider that MITs and similar “fixed” trusts (i.e. “MIT-like entities”) should be excluded from any legislative changes relating to the definition of “net income” or “distributable income”. This is because MITs (and MIT-like entities), particularly in the property sector, have trust deeds which entitle unitholders to a proportionate share of the income of the trust which does not generally include capital gains. Continuing the property trust example, this is so that the proceeds from the sale of a property can be reinvested into another. The unitholders will be subject to tax on the same share of the taxable income, which would be higher than their share of the income of the

trust in a year in which a capital gain was made. There is generally no problem with this, because the unitholders receive the economic benefit of the capital gain, as it is reflected in the value of their units.

This practice of retaining the capital gain is set out in the trust deed and is also explained in the fund's product disclosure statement, where applicable. Therefore, unitholders are well aware of the practice and the commercial reasons for adopting it.

We consider that it is undesirable to bring MITs (and MIT-like entities) into any new regime for the current income year, as they are soon to be subject to new the new MIT attribution rules (which are due to commence on 1 July 2011). It would cause administrative difficulties for these funds to be subject to different regimes in a short period of time.

However, MITs and MIT-like entities should be availed of the certainty in respect of the streaming of tax attributes such as franking credits and discount capital gains.

## 7 The need for ongoing reform

As stated in the Assistant Treasurer's press release which accompanied the release of the Discussion Paper, the Government is "*aware that these interim changes will not resolve all of the issues with the current operation of the trust income tax provisions*". Even with the alternative "interim solution" approach that we have suggested, many uncertainties and inequities will continue to exist in the tax law that applies to trusts.

It is critical that the Government harnesses the current momentum in this reform project and proceeds with a comprehensive revision of Division 6 (as was recommended in the Henry Review). Due to the complexity of the issues involved, and the variety of reform ideas that are likely to be suggested, we urge the Government to commence this project as soon as possible.

## 8 Specific responses to the consultation questions

We consider that we have addressed most of the consultation questions in sections 1 to 7 above. However, for the ease of reference, we have specifically responded to the questions in summary form below.

***Better aligning the concepts of distributable and taxable income***

***Q1 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 available discounts)?***

***Q2 Should all notional amounts (for example receipts or expenses) be excluded from a definition of distributable income based on the concept of taxable income, or are there some notional amounts that should be included?***

***Q3 Would adjustments to the definition of distributable income also be needed where timing differences exist between the distributable income (as newly defined) and the trustee's calculation of 'income' pursuant to the terms of the trust deed? How could this be achieved?***

As we have stated in section 3 above, we do not believe that trust income should be defined by reference to tax concepts or any other concept.

Having to apply a test of "present entitlement" to the defined concept of "distributable income" will create issues for trusts as a trust constitution will not usually create a "present entitlement" to all items that comprise the tax law notion of "distributable income". This is no different to the current problems that subsist between trust income and tax income and, in The Tax Institute's view, does not address the fundamental problem. As present entitlement cannot be created in all items that constitute the defined "distributable income" it would seen that no-one is presently entitled to these differences and therefore such amounts will be taxed to the trustee at 46.5%. This will clearly be an issue for any trust.

As we have set out in section 3.1 above, there are primarily two instances where it will be difficult to see that beneficiaries are "presently entitled" as a matter of trust law to some of the trust's "distributable income":

- *Where there are amounts included in "distributable income" that are simply amounts that do not exist* – either because they are tax fictions or they represent part of the net income that has been expended on non-deductible items. In such cases it is not possible to either physically distribute or make a beneficiary entitled to such amounts.

  The tax law works by allocating the tax liability to the person who is "presently entitled" to some amount – an amount that will now be termed "distributable income" – and in order for a person to be "presently entitled" they must be in a position to demand payment of an amount. In reality, no unitholder can demand payment of these amounts, and so cannot obviously be said to be "presently entitled" to them. (Nonetheless, we note that the amount may have been expended for the benefit of beneficiaries either specifically or generally.) In that circumstance – if no beneficiary can demand payment of the fictitious components of the "distributable income" – there is uncertainty about what follows. While the Discussion Paper recognises this issue and suggests that modifications will be made to "distributable income" to exclude some fictitious amounts, it is a new patch to solve a problem with the solution itself. Such an approach does no more than identify the problems that arguably are a creation of the solution itself and in any event the patch is unlikely to capture all such problems.
- *Where a trustee decides, or the trust deed provides, that some portion of the "distributable income" will not be disbursed in cash* - for example, in the case of a property trust where it is commonplace to not distribute a realised capital gain (and thus reduce the amount of cash distributed). Again, the unitholders cannot demand payment of these amounts, and so, under the formulation of "distributable income" proposed, cannot be said to be "presently entitled" to them. In that circumstance – if no beneficiary can demand payment of this component of the tax law's "distributable income" – there is uncertainty about what follows.

We consider that as all of the models set out in the Discussion Paper will cause difficulties in practice, it is best to introduce the "interim solution" that we have suggested in section 2 above. A broader examination of the concept of "distributable income" could take place as part of the ongoing reform process.

***Q4 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?***

***Q5 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?***

We have set out our reservations against introducing a specific anti-avoidance provision at section 5 above. However, an appropriately drafted positive integrity test could be utilised to overcome concerns about possible manipulation.

If our suggestion is adopted, then this particular question becomes redundant.

***Streaming of certain trust amounts***

***Q6 Apart from clarifying the operation of subsection 207-35(3) of the ITAA 1997 (in particular the meaning of the words 'despite Division 6') are other changes needed to ensure that Subdivision 207-B operates appropriately?***

We agree with the matters that have been set out in section 3.1 of the Discussion Paper. To the extent there is in fact an issue with the effectiveness of the streaming mechanism in section 207-35(3), we agree that amendments may be required to Subdivision 207-B to reflect the policy of allowing streaming.

We have not comprehensively analysed whether other changes are necessary to ensure that the streaming in Subdivision 207-B operates effectively. Whilst we have not identified other required changes, we are not able to rule out that there may be other fact scenarios that would require consequential amendments.

We would like to point out that under current law, the whole of the franking credit can flow to beneficiaries, as long as there is at least $1 of net income of the trust. That was a deliberate amendment at the time of re-writing the imputation provisions into the ITAA 1997 and should not be lost in this amendment process.

***Q7 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?***

If the approach to streaming is to amend Subdivision 115-C, then the provision needs to acknowledge that the trustee has allocated an amount to a particular beneficiary. It is then that beneficiary that would be required to apply Subdivision 115-C type principles. Consequential amendments would need to be made to ensure that beneficiaries that did not have capital gains streamed to them do not apply Subdivision 115-C.

We have not comprehensively analysed whether other changes are necessary to ensure that the streaming in Subdivision 115-C operates effectively. Whilst we have not identified other required changes, we are not able to rule out that there may be other fact scenarios that would require consequential amendments.

If amendments are made to Subdivision 115-C, care must be taken to ensure that the availability of the relevant discount/s (e.g. the 12 month holding concession and the small business concessions) are not jeopardised.

***Q8 Instead of looking to amounts assessed to beneficiaries under Division 6, should Subdivision 115-C instead look to the trust entitlements of the beneficiaries?***

The linking with Division 6 is still important. If an entitlement basis is used, it could mean that a difference between which beneficiary is assessed and the person to whom Subdivision 115-C applies.

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