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TCA

Trustee Corporations Association of Australia

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

Dear Sir

Improving the taxation of trust income

The TCA is the peak representative body for the trustee corporations industry in Australia.

It represents 16 organisations, comprising all 8 regional Public Trustees and the great majority of the 11 private trustee company groups.

Each year our members:

- administer about 9,000 deceased estates.
- write about 60,000 wills and powers of attorney.
- manage assets under agency arrangements or Court and Tribunal orders for about 45,000 people.
- manage about 2,000 charitable trusts and 15,000 other personal trusts.
- prepare over 40,000 tax returns.

We appreciate the opportunity to comment on the discussion paper *Improving the taxation of trust income.*

It is unfortunate that stakeholders have not been given more time to consider this important matter.

However, we understand that the proposed changes, to apply from the 2010-11 income year, will be subject to further consideration as part of the broader review to be conducted later in the year.

Problems arising from the terms ‘share’, ’income’ and ‘net income’

As you are aware, Division 6 of the Income Tax Assessment Act 1936 operates so that if a beneficiary is required to return the trust's taxable income in its own assessable income, then there can be no liability for the trustee of the trust.

In relation to beneficiaries who are residents and not under any legal disability the core taxing provision is s97(1)(a) which reads as follows.

> *Where a beneficiary of a trust estate who is not under any legal disability is presently entitled to a share of the income of the trust estate:*
>
> *(a) the assessable income of the beneficiary shall include:*
>
> > *(i) so much of that share of the net income of the trust estate as is attributable to a period when the beneficiary was a resident; and*
> >
> > *(ii) so much of that share of the net income of the trust estate as is attributable to a period when the beneficiary was not a resident and is also attributable to sources in Australia;*

The effect of section 97(1)(a) is that where a beneficiary of a trust is presently entitled to a ***share*** of the ***income*** of that trust, that beneficiary must include that ***share*** of the trust's total ***net income*** in that beneficiary's own assessable income. [**emphasis added.**]

Prior to the decision of the High Court in *Bamford*, there was considerable uncertainty as to the meaning of the terms ‘share’ and ‘income’.

More particularly, there were two alternative approaches to the meaning of the term ‘share’.

The first approach was commonly called the *proportionate* approach. Put simply, the proportionate approach provides that if a beneficiary is entitled to (say) 20% of the income of a trust, then that beneficiary must include in its assessable income, 20% of the taxable income of the trust.

This is the case notwithstanding the fact that the taxable income could be significantly more, or less than, the income of the trust estate.

The alternative approach, which is known as the *quantum* approach, simply required the beneficiary to include in its assessable income no more than the amount of trust income to which it was presently entitled.[1] The quantum approach leads to the trustee of the trust being taxed when the taxable income of the trust exceeds the income of the trust.

There was also significant uncertainty as to the meaning of the term ‘income of the trust estate’.

[1] Even less if the taxable income of the trust estate less than the income of the trust

One view was that the term referred to that which was income according to ordinary concepts and usages. Upon this interpretation, the meaning was fixed and could not be displaced or supplemented by any definition of income or other power as set out in the trust deed.

On the other view, income actually referred to the income available for distribution for trust law purposes which meant that reference had to be had to the terms of the relevant trust deed including any powers exercised by the trustee pursuant to the deed.

The High Court in Bamford found that the proportionate approach was the correct approach in determining the meaning of the term ‘share’. The High Court also adopted the latter view of the definition of income being, distributable income as defined by trust law, having regard to the terms of the trust deed.

The High Court acknowledged that no matter what approach was adopted in relation to the meaning of the terms ‘share’ and ‘income’, anomalies arise.

In our view the most significant anomaly that can arise as a consequence of the High Court's decision is that it is possible for a beneficiary of a trust estate to be taxed on an amount that they do not receive.

Whilst in some cases the aligning of distributable income of a trust with the taxable income of a trust can overcome this anomaly, it can produce other anomalies that may be even more problematic. For example:

- In order to align distributable income with the taxable income of a trust, it may require, in some circumstances, a trustee to deem a capital receipt as an income receipt. This would cause inequities as between the beneficiaries if there were different income beneficiaries and capital beneficiaries.
- Often the taxable income of a trust estate can include notional amounts, eg: franking credits, attributable foreign income and deemed capital gains. To render the distributable income of the trust equal to the taxable income of the trust in such circumstances would mean the trustee would be required to pay out amounts to beneficiary that the trust estate did not have.
- It simply many not be possible to align the terms, either because the deed does not allow it or because it would not be in the best interests of a particular class of beneficiaries.

<u>Better aligning distributable income and taxable income</u>

Given the anomalous outcomes that can arise from the mismatch between ‘taxable income’ and ‘distributable income’, we firmly believe that initiatives to more closely align the two concepts are necessary, and indeed are long overdue.

Many trust deeds do not have income equalisation clauses as distributions made pursuant to these clauses may not always reflect the true wishes of the settlor or testator in terms of beneficial entitlement from the trust.

Equalisation, for the specific purpose of correctly apportioning taxation liability, is therefore needed, through legislative amendment.

A fair system requires that beneficiaries are taxable only on amounts of trust income to which they are presently entitled.

While none of the options put forward in the discussion paper are ideal, we favour the first option, ie: equating 'distributable income' with the 'net income of the trusts estate' (as defined in s95).

As regards Question 1 in the discussion paper, if a *discount* gain is included in taxable income, the relevant amount to be included in the proposed definition of distributable income under tax concepts appears to be the *discount* capital gain – as the following example illustrates:

> A trust derives interest of $100 and a capital gain of $300 which gave rise to a discount capital gain of $150 and a taxable income of $250. If A is entitled to capital and B to income, A will be entitled to $300 which is 75% of the distributable income ($400) and A therefore assessed on 75% of the taxable income i.e. $188.
>
> If however, the distributable income includes the *discount* capital gain, A will be entitled to $150 which is 60% of the distributable income ($250) and the amount to be included in A's assessable income will be $150.

Further, we would wish to ensure that the trustee has access to concessions such as the 50% discount on CGT where the income/capital gains would be assessed in the trustee's hands.

This could be achieved by the adoption of a modified 'quantum approach' operating on the current definition of income; ie: fundamentally, a beneficiary would only be assessed on amounts that they received.

The balance of the taxable income that was not received by a beneficiary would be taxed in the hands of the trustee. To the extent that such taxable income attracts concessions or credits (eg: CGT discount or franking credits) then those concessions and credits would be available to reduce the trustee's liability.

We believe that this approach could be adopted with minimal legislative change and would result in fewer anomalies.

It gives the trustee the option to equate trust income with taxable income, but does not impose an oppressive tax burden upon trustees if it does not.

Further, it addresses the tax risks that the tax authorities have identified that flow from the proportionate approach as it will not be possible to shelter income without giving that amount to the relevant taxpayer."

<u>Streaming</u>

(i) Franking credits

Streaming different classes of income to different beneficiaries is an important feature of many trust deeds.

Amendments to subdivision 207-B to enable streaming of franked dividends, with the right amount of franking credits attached, would be welcome.

(ii) Capital gains

Similarly, members believe that changes to subdivision 115-C to override the impact of the proportionate approach and thereby enabling the streaming of capital gains, as given in example 9, also should be implemented.

This would enable beneficiaries who are entitled to either capital or income of the trust to more accurately reflect their entitlement as opposed to the current system where the share of ‘net income of the trust estate is spread across the classes.

As regards Question 8, we suggest that the simpler approach would be for subdivision 115-C to look at trust entitlements.

Yours faithfully

Ross Ellis
Executive Director