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Dear Sir

Submission on "Modernising the taxation of trust income - options for reform" consultation paper

Thank you for the opportunity to comment on Consultation Paper "Modernising the taxation of trust income – options for reform" November 2011 (**Consultation Paper**).

1. Preferred approach to the taxation of trusts

Without having regard to practical implementation issues, we consider that the "trustee assessment and deduction model" (**TAD Model**) is the preferable approach to the taxation of trusts because of its relative simplicity and because it resolves many of the anomalies and issues with the existing system. However, given that the implementation of this model would require extensive change and would impact on the tax treatment of an enormous number of existing trusts (many of which will have been drafted with the existing framework in mind), the adoption of an approach based on the concepts found in the current framework may be a more realistic option.

2. Patch model and proportionate within class

Given that it would seem more realistic to broadly maintain the existing framework for the taxation of trust income, we have set out in **Annexure A** and **Annexure B** our submissions on the possible changes that could be made to improve issues and anomalies with the existing framework. In summary, the current approach of relying on general trust law principles should be maintained and the concept of present entitlement should also be maintained, but with modifications to provide greater flexibility and certainty. We also propose that the existing framework should be considerably simplified and we consider this is possible without significantly affecting the outcomes which currently apply for the taxation of trust income.

3. Trustee assessment and deduction model

We consider that the implementation of the TAD Model would improve the simplicity and clarity of the taxation of trusts. It reduces the reliance on trust deeds and trust concepts and should be relatively easy for taxpayers to understand. Further, if the model is similar to one

or more of the models used in the USA, Canada or New Zealand, case law and interpretive materials from the relevant jurisdiction(s) could be useful to assist in dealing with any uncertainties in the Australian version of the model.

As identified in the Consultation Paper,[1] the TAD Model meets the first, second, third and fourth policy principles outlined in chapter 1 of the Consultation Paper. It should also be able to be designed to meet the fifth policy principle (trapping losses in trusts).

The concept of a "distribution" under the TAD Model should include:

(a) cash and *in specie* distributions to a beneficiary;

(b) cash and *in specie* distributions applied for the benefit of or at the direction of a beneficiary; and

(c) the application of an amount as a reinvestment into the trust by way of an additional contribution for the interest held by the beneficiary (for non-discretionary trusts only).

As indicated in the Consultation Paper at part 8.3.1, we agree that the quantum of the deduction for a distribution should reflect the taxable income relating to the distribution (eg gross up for franking credits). This should result in beneficiaries paying the appropriate amount of tax and reduce the risk of trustee assessments caused by differences between taxable amounts and amounts that can be distributed.

Part 8.3.3 of the Consultation Paper notes that the TAD Model increases the risk of trustee assessments, including in relation to unintentional unallocated amounts. We consider that the most appropriate way to deal with such accumulations would be to reduce the rate of tax imposed upon the trustee under the TAD Model to 30%, with appropriate integrity measures introduced to prevent intentional tax manipulation. Another possibility might be to allow all of the beneficiaries of a trust to jointly elect to be taxed on the income of the trust in proportion to the distributions (as that term is defined for the purposes of the TAD Model) received by each beneficiary.

Where a trustee assessment does arise, beneficiaries should receive a credit for the tax paid by the trustee to be applied to future distributions of the taxed trust income. It should also continue to be possible to make tax deferred distributions to beneficiaries.

Retention of the character and the source of income should continue and streaming should be permitted if the trustee has the power to do so under the relevant trust deed.

Some uses of trusts require the trust to be "tax neutral", for example, securitisation special purpose trusts. In order to ensure that these trusts are not adversely affected by the change in the tax treatment of trusts, transitional rules should allow trust deeds to be amended to ensure that reinvestment into the trust is permitted without the changes giving rise to a resettlement that is subject to tax and/or to allow all of the beneficiaries of a trust to jointly [and irrevocably] elect to be taxed on the income of the trust in proportion to the distributions (as that term is defined for the purposes of the TAD Model) received by each beneficiary. Provided that reinvestment into the trust is permitted to be classed as a distribution, new special purpose trusts should be able to ensure appropriate drafting of the trust deed to achieve tax neutrality if required.

[1] At part 8.3 of the Consultation Paper.

4. Tax rate under section 99A

We submit that, whichever model is adopted, serious consideration be given to reviewing the current tax rate which applies to trustees where income is retained in the trust (currently 46.5% where section 99A applies). While we understand the integrity concern of imposing a tax rate at the highest individual marginal tax rate (ie to avoid income which would otherwise be distributed to a high rate individual being accumulated in the trust) in many cases this will be excessively punitive.

We submit consideration be given to:

- aligning the trustee rate with the corporate rate where the beneficiaries of the trust were corporate tax entities for the whole of the relevant income year; and
- imposing a lower trustee rate where the trustee can demonstrate that the average tax rate of the beneficiaries in a fixed interest trust is less than 46,5% (eg where 50% of the fixed interests in a trust are held by complying superannuation funds); and
- aligning the trustee rate with the corporate rate where money is paid into court and held by a trustee and no beneficiary has an entitlement to the income of the trust at the end of the tax year.

5. Questions for consultation

5.1 Do the policy principles outlined in Chapter 1 accurately reflect the existing framework for the taxation of trusts?

The policy principles outlined in Chapter 1 reflect the manner in which the existing framework should ideally work. However, there are a number of problems with Division 6 (as identified in the Consultation Paper) that mean that Division 6 does not always operate in a manner that complies with these policy principles.

For example, if the "net income" exceeds the "income of the trust estate", a beneficiary might be taxed on an amount greater than the amount they receive. If this occurs, the tax liability does not "follow the money" as contemplated in the first principle (although see our suggestion in Annexure B that trustees and beneficiaries be given the ability to agree that the trustee pays tax where net income exceeds the income of the trust estate). Additionally, recent cases such as *Commissioner of Taxation v Bamford* [2010] HCA 10 and *Colonial First State Investments Ltd v Commissioner of Taxation* [2011] FCA 16 suggest that principles 2-4 are not always met because Division 6 continues to be uncertain, including in relation to the permissibility of streaming (noting that this has been corrected in relation to franked distributions and capital gains), and provide opportunities for the manipulation of tax liabilities.

5.2 The Government has identified a number of areas of the trust income tax provisions that require immediate reform. Are these the areas in most need of immediate reform? If not, what areas should the Government seek to reform as a priority?

We agree that the Government has identified the areas of the trust income tax provisions in most need of reform.

Whether or not Division 6 is updated, there are a number of existing issues in relation to the interaction between Division 6 and other parts of the tax law. See Annexure A.

5.3 Should the trust income tax provisions be updated and rewritten as part of a single process or would it be more appropriate to conduct this reform through a staged approach?

We consider that it would be preferable to update and rewrite the trust income tax provisions as part of a single process to reduce the risk of inconsistencies and confusion resulting from dealing with partially rewritten provisions. This should also ensure that the rewritten provisions are laid out and numbered in a logical way. A staged approach to rewriting the provisions is likely to require additional complexity to ensure that the existing and rewritten parts of the provisions interact as intended.

We note that, to the extent that it can be done without creating uncertainty, it would be preferable to use a simple, principles based style of drafting.

5.4 Uncertainty about the scope of Division 6 is arguably one of the key issues hampering the effective taxation of trust income. If the scope of Division 6 is clarified, under either an inclusion or exclusion approach, should a general principle or a comprehensive list be adopted?

Division 6 should apply to most types of trusts where the trustee has powers other than merely to hold the trust estate (see further comments at 5.5 below), but would not apply to trusts covered by another regime such as superannuation entities and FHSA trusts; it may also be appropriate to exclude MITs when the comprehensive regime for MITs is introduced).

In this case, we consider that if an inclusion approach is adopted, it would be preferable to adopt a general principle approach to outline which trusts Division 6 will apply to. This is consistent with the use of "principles based" drafting in recent legislative amendments to the tax legislation and should also improve simplicity since it is intended that most trusts will be within the Division. If appropriately drafted, the use of a general principle should also be able to apply appropriately to any new trust situations that may arise that have not yet been contemplated.

If an exclusion approach is adopted, we consider that it would be preferable to introduce a comprehensive list of types of trusts that are excluded from the operation of Division 6. We expect that such a list would not be overly long and, accordingly, it would improve simplicity and clarity. The list could include some limited flexibility (such as allowing a trustee to apply to the Commissioner to determine that the trust should be excluded from the operation of Division 6) to address any situations where a trust would most appropriately be dealt with outside Division 6 but does not fall within the types of trusts that are specifically listed.

5.5 What types of trust might it be appropriate to carve out of the operation of Division 6? Are there any other areas of the tax law where a similar carve out for these types of trust may or may not be appropriate?

See comments in Annexure A.

5.6 Is there sufficient uncertainty with the current treatment of expenses to warrant a legislative solution?

We do not wish to comment on this question.

5.7 **If the concept of distributable income is to be defined using tax concepts, what adjustment will need to be made to existing tax concepts to allow for a workable definition?**

We consider that the "Patch model" described in part 8.1 of the Consultation Paper and the "Proportionate within class model" described in part 8.2 of the Consultation Paper (with a definition of "distributable income" as contemplated in parts 8.1 and 8.2.1 of the Consultation Paper) would not operate as intended if the concept of "present entitlement" is retained in the legislation. The reasons for this are set out in our submission in relation to the "Improving the taxation of trust income" discussion paper dated 18 March 2011 (**enclosed** as **Annexure C**).

See Annexure B.

5.8 **Should character flow-through and "streaming" be provided on a general basis with specific limitations or alternatively through the use of specific provisions? If "streaming" is provided using specific provisions, in addition to capital gains and franked distributions what other types of income should be afforded this treatment?**

See Annexure B.

5.9 **How should losses be dealt with where character flow-through of different classes of income is recognised?**

We have covered this issue in a general way in Annexure B. We suggest that this issue be considered further at a later stage.

5.10 **In addition to those areas of the tax law highlighted in Chapter 4, are there any other areas that may need to be updated if changes are made to the current operation of Division 6?**

See Annexures A and B.

5.11 **Are there issues with the operation of the provisions highlighted in Chapter 4 that may need to be addressed, in addition to any changes that may need to be made to ensure that these provisions are able to operate effectively with an updated version of Division 6?**

See Annexure A and B.

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

Please see our comments at part 1 above.

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

See Annexure B.

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

Please see our comments at part 3 above.

5.15 If a TAD model was adopted, how should the tax law define the concept of a "distribution"?

Please see our comments at part 3 above.

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

The Government should provide a form of rollover relief in relation to the resettlement of any trust that occurs solely because changes are required to be made to the relevant trust deed to ensure that the amendments to the tax law do not adversely affect existing trusts. For example, if a trust deed has been drafted to ensure that all of the "income of the trust estate" is distributed so that the beneficiaries (and not the trustee) are subject to any tax on the trust income, the trust deed should be permitted to be amended to ensure that this continues to be the case, provided that relative entitlements as between beneficiaries are not changed in doing so.

The precise nature of the rollover and any other transitional relief that may be required should be revisited once the preferred approach to the taxation of trust has been finalised.

Yours faithfully

Blake Dawson

ANNEXURE A: SUMMARY OF AUSTRALIAN INCOME TAX RULES AFFECTING TRUSTS OTHER THAN CHARITABLE TRUSTS

TYPE OF TRUST & ELIGIBILITY CRITERIA	INCOME/GAINS/ LOSSES AFFECTED	EXISTING RULES	CHANGES PROPOSED BY GOVERNMENT	SUBMISSION
1. BARE TRUST AND SECURITY TRUST The categories "bare trust" and "security trust" do not yet exist in Australian tax law. The main characteristic of a bare trust is that the beneficiary is the absolute beneficial owner of the trust property. A security trust is similar to a bare trust except that a person to whom the beneficiary owes an obligation may intervene to prevent the transfer of the trust property to the beneficiary, and may become entitled to some or all of the proceeds of disposal of the trust property, if the beneficiary defaults on the obligation.	All income, gains and losses	Under an administrative concession, a trustee of a "Transparent Trust" or a "Secured Purchase Trust" is not required to lodge a tax return: ATO Practice Statement PS LA 2000/2. In practice all income of the trust is treated as income derived directly by the beneficiary.	None	We consider that it would be appropriate to provide "full flow through" treatment for income, gains and losses arising in: (a) bare trusts; (b) constructive trusts; and (c) resulting trusts. As recognised in part 3.1 of the Consultation Paper, these terms do not necessarily have a fixed or certain meaning in all cases. Accordingly, if a comprehensive list approach is used to exclude these types of trusts from the operation of Division 6 , it may be necessary to provide appropriate definitions or list these types of trusts based on their features rather than merely listing the labels commonly applied. Key characteristics that could be used to define a bare trust are: (1) a single beneficiary (or possibly a fixed group of beneficiaries in fixed percentages) has an absolute, indefeasible entitlement to all of the capital and income of the trust; and (2) the trust does not provide the trustee with powers other than to merely hold the trust estate. We submit that this treatment should be extended to income, gains and losses derived through a "Secured Purchase Trust" as defined in PS LA 2000/2 and other forms of security trust. The law should make it clear that where a trust of this nature is carved out of Division 6, income and gains derived through the trust are taken to be derived directly by the beneficiary (or beneficiaries in fixed percentages) for income tax purposes.

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2. CORPORATE UNIT TRUST Certain "widely held" trusts operating businesses previously operated by a company	All income, gains and losses	Taxed as if the trust were a company: Div 6B of Part III of ITAA 1936	Abolish Div 6B – no longer has any practical application: Assistant Treasurer's Media Release No 86 of 7 May 2010.	
3. PUBLIC TRADING TRUST Certain "widely held" trusts deriving income other than from eligible investment business	All income, gains and losses	Taxed as if the trust were a company: Div 6C of Part III of ITAA 1936	The Federal Government announced as part of the 2010 Budget that the definition of "public unit trust" would be amended so that complying superannuation entities would not be treated as "exempt entities" for the purposes of Division 6C. This implementation of this proposed change has been deferred until 1 July 2013 as part of the recent Mid-Year Economic and Fiscal Outlook.	Consideration should be given to reviewing the definition of "eligible investment business" so that it is more flexible and includes a wider variety of passive investments. A public trading trust should be deemed to be a company in the same way that a public trading trust that is a head company is current treated under Subdivision 713-C of the *Income Tax Assessment Act 1997.*
4. MANAGED INVESTMENT TRUST The trustee must be an Australian resident or the central management and control of the trust must be in Australia. The trust must be a "managed investment scheme" as defined in the *Corporations Act 2001*. It must not be a trading trust as defined in Div 6C of the ITAA 1936 (see 3 above) and must not carry on or control a trading business. A substantial portion of the investment management activities of the trust in respect of certain Australian assets of the trust must be carried on in Australia. The trust must satisfy the "widely-held" requirements and the "closely held restrictions" in Div 12H of Sch 1 to TAA 1953.	Gains and profits on disposals of "eligible assets", ie shares, non-equity interests in a company, units in a unit trust, real property and rights or options to acquire or dispose of any of those assets – but excluding "financial arrangements" under Div 230 and debt interests under Div 974.	Trustee can elect that the CGT provisions and not the income tax provisions apply to such disposals. If no such election is made: • ins on disposals of such assets (other than land, an interest in land or an option to acquire or dispose of land) will be on revenue account; • the character of gains on disposals of land, an interest in land or an option to acquire land will be determined according to general tax law principles.	The Government has announced that a new tax code for MITs will be developed and will contain the following features (Assistant Treasurer's Media Release No 86 of 7 May 2010): 1. The general trust income assessing provisions in Div 6 (see 10 below) will not apply to qualifying MITs. 2. Qualifying MITs will be treated as fixed trusts. 3. Over and under distributions will not result in tax penalties within a 5% tolerance band. 4. Double taxation arising from CGT cost base adjustments under the existing law will be removed. The detailed design of the MIT system will be the subject of consultation with industry. The Government has announced that the commencement of the new MIT regime has been deferred to 1 July 2013: Treasurer's Mid Year Economic Review of November 2011.	Align definition of widely held trust with proposed definition in future IMR rules – allowing look-through to ultimate owners through a wide variety of internationally recognised collective investment vehicles (ie not only trusts), as contemplated under the proposed IMR rules: see 6 below.
	Amounts of trust income distributed to non-residents other than amounts to which the withholding tax provisions in Div 11A of Part III of the ITAA 1936 apply	Subject to withholding tax at 30%, reduced to 7.5% for payments to recipients in jurisdictions which have acceptable information exchange arrangements: Subdiv 12-H in Sch 1 to the TAA 1953. Income that "gives rise to" an amount from which withholding is required is exempt from tax under Div 6: s 99G of ITAA 1936		We consider that the MIT rules which apply to income and gains distributed to non-residents can co-exist with the application of general trust assessing rules for income distributed by MITs to resident beneficiaries if those general rules are modified as described in Annexure B. Alternatively, provide a blanket exclusion of MITs from Div 6 taxation (eg as for FHSA trusts – see section 95AA of the *Income Tax Assessment Act 1936*). This seems to be the Government's preferred approach. In the latter case, ensure that the new code for MITs does not result in a greater tax cost for Australian resident beneficiaries than is currently the case. In particular, ensure that tax preferred income retains its character when distributed to Australian resident investors.

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5. IMR FOREIGN FUND (ie a trust within the "investment manager regime" rules) The "IMR foreign fund" may be a company, trust, partnership or contractual arrangement. It must not be a resident of Australia at any time in the income year. It must be recognised as a collective investment vehicle under foreign law. It must be domiciled in a country recognised by Australia as having effective exchange of information arrangements. Its members must not have day-to-day control of its operations. It must not conduct a trading business in Australia. It must satisfy the "widely held" tests in the MIT provisions: see item 4 above.	"IMR income" - ie income satisfying the following criteria: (a) the income is attributable to a financial arrangement (except where the IMR foreign fund has a participation interest in the issuing entity of 10% of more, or the financial arrangement is a derivative financial arrangement: • that relates to a debt or equity interest in an entity in which the IMR foreign fund has a participation interest 10% or more, or • that relates directly or indirectly to taxable Australian real property); and (b) the income would not be taxable in Australia but for • the operation of a "deemed Australian source" provision in a taxation treaty or the *International Tax Agreements Act 1953*, or • a determination made by the Commissioner of Taxation under the Australian transfer pricing rules in relation to source of income, or • the financial arrangement is a CGT asset that is "taxable Australian property" because it has been used in an Australian permanent establishment or it is an option or right to acquire such an asset. "IMR losses" – ie deductions attributable to gaining the fund's IMR income. "IMR capital gains" and "IMR capital losses" – ie capital gains and losses attributable to financial arrangements described in (a) above, where the gain or loss is from a CGT asset that is "taxable Australian property" because it has been used in an Australian permanent establishment or it is an option or right to acquire such an asset.		Commissioner to be prevented from assessing IMR income or an IMR loss for the 2010/11 and prior income years where the fund had not lodged an income tax return for the 2010/11 income year or any previous income year by 18 December 2010 and the Commissioner had not notified the fund of an audit or compliance review by that date: Proposed s 842-5 of the *Income Tax (Transitional Provisions) Act 1997* Commissioner to be prevented from assessing IMR income or an IMR loss for the 2010/11 and prior income years in the hands of a non-resident beneficiary or partner of an IMR fund, or an entity "ultimately entitled" to a share of IMR income, if the entity had not lodged an income tax return for the 2010/11 income year or any previous income year by 18 December 2010 and the Commissioner had not notified the fund of an audit or compliance review by that date: Proposed s 842-10 of the *Income Tax (Transitional Provisions) Act 1997.* For 2011/12 and subsequent income years, "IMR income" to be treated as non-assessable non-exempt income. "IMR losses", "IMR capital gains" and "IMR capital losses" to be disregarded in working out the taxable income of an IMR foreign fund or the trustee of an IMR foreign fund if the entity: • does not have a place of business in Australia but • is treated as having a permanent establishment in Australia solely as a result of engaging an Australian based investment manager who habitually exercises a general authority to negotiate and conclude contracts on behalf of the entity: Proposed s 842-210 of the *Income Tax Assessment Act 1997.* Note that this regime will be modified after further consultation: see 6 below.	
6. TRUST WITHIN FINAL VERSION OF THE IMR RULES The forward-looking aspect of the "IMR foreign fund" rules described in 5 above are to be expanded after consultation with industry. Eligibility criteria are subject to consultation. Board of Tax recommendations accepted by	Subject to consultation. Board of Tax recommendations accepted by the Government so far are similar to the exemptions described above but in addition will cover gains made by a foreign fund on the disposal of portfolio investments in non-Australian assets. Dividend, interest and royalty income that is		Subject to consultation but the scope of the exemptions will be similar to the exemptions in 5 above; ie IMR income will be non-assessable non-exempt and IMR losses, IMR capital gains and IMR capital losses will be disregarded in assessing an IMR foreign fund or a non-resident partner or beneficiary in an IMR foreign fund. The final version of the IMR regime will apply	In determining whether an IMR foreign fund is widely held, the IMR rules should allow a look-through to ultimate owners through a wide variety of internationally recognised collective investment vehicles.

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the Government to date are similar to the criteria for an "IMR foreign fund" set out above except that: • the "widely held" test is to be applied on a "look through" basis (ie it is likely to allow further look through than the present test); and • the prohibition on conducting a trading business will apply only to a trading business carried on in Australia.	subject to Australian withholding tax will be specifically excluded (but would in any case not be covered by the existing definition of "IMR income").		with retrospective effect from 1 July 2011.	

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7. SPECIAL DISABILITY TRUST	All income and gains	Taxed under Div 6 of Part III of ITAA 1936 with specific modifications: s 95AB.		Consideration will need to be given to modifications which are required to deal with redrafted Division 6. For example, is deemed present entitlement of principal beneficiary sufficient,
8. FIRST HOME SAVINGS ACCOUNT (FHSA) TRUST OFFERED BY AUTHORISED TRUSTEE	All income and gains	Income and gains taxed at 15% in the hands of the trustee: s 345-5 of the ITAA 1997 and s 30 of the *Income Tax Rates Act 1986.* Excluded from Div 6 of Part III of ITAA 1936: s 95AA .		
9. TRUST OPERATING AS SUPER-ANNUATION FUND OR A POOLED SUPERANNUATION TRUST (PST) OR AN APPROVED DEPOSIT FUND (ADF)	All income and gains	Special taxation rules in Div 295 of ITAA 1997 modify the general assessing rules. Not covered by Div 6 of Part III of ITAA 1936.		Superannuation entities should be specifically excluded from Division 6.
10. FOREIGN TRUST TO WHICH AN AUSTRALIAN RESIDENT HAS TRANSFERRED PROPERTY OR SERVICES	All income and gains	Taxed in accordance with Div 6 of Part III of ITAA 1936. Also taxed in the hands of an Australian resident transferor to the trust under Div 6AAA, but the amount so assessed is reduced by the amount assessed under Div 6.	In the 2003-4 Federal Budget it was announced that the control requirement would be removed. However, that announcement has never been implemented. The Rudd Government announced in the 2008-2009 Federal Budget that this proposal would be examined by the Board of Taxation in the course of the Board's wider review of the foreign source income anti•tax deferral rules, including the transferor trust rules. The Board of Taxation recommended that the control requirement for pre-commencement and pre-resident transferor trusts be removed and that further technical issues with the transferor trust rules would be considered as part of consultation on any draft legislation. The Rudd Government announced in the 2009-2010 Federal Budget that it would adopt the Board of Taxation's recommendation.	
11. ALL TRUSTS UNLESS SPECIFICALLY EXCLUDED Excluded trusts are those mentioned in 1, 2, 3, 8 & 9 above.	All income and gains except those amounts specifically covered below	Generally taxed in the hands of beneficiary to the extent that the beneficiary is presently entitled to the "income of the trust estate"; otherwise taxed in the hands of the trustee. Taxed in the hands of the trustee and the beneficiary (with a credit for tax paid by the trustee) if the beneficiary is a non-resident at the end of the income year. Generally taxed in the hands of the trustee if the beneficiary is under a legal disability. Non-Australian source income derived while a beneficiary was a non-resident generally excluded. Distributions of previously untaxed amounts taxed in the hands of the beneficiary.		See attached suggestion (Annexure B) for redrafting the mechanical provisions of Div 6 to ensure that: 1. trusts that are entirely excluded from the general trust income assessing rules are clearly identified; 2. specific exclusions from Part 6 (see below) operate more effectively; 3. rules allocating amounts to be taxed in the hands of beneficiaries are appropriate and do not result in beneficiaries paying tax on types or amounts of income or gains that will in fact be retained by the trust or distributed to other beneficiaries; 4. the character of amounts derived by the trust is retained when taxed in the hands of

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				beneficiaries; 5. amounts taxed in the hands of trustees are taxed at an appropriate rate; and 6. the rules regarding the taxation of distributions of previously untaxed amounts apply in a reasonable manner.
	Franked distributions	Excluded from Div 6 of Part III of ITAA 1936. Taxation implications are dealt with in Subdiv 207-B of ITAA 1997.		The suggested redraft of Div 6 should allow Subdiv 207-B to be simplified considerably: see Annexure B.
	Capital gains	Excluded from Div 6 of Part III of ITAA 1936. Assessed under the capital gains tax rules: s 115-215 of ITAA 1997		The suggested redraft of Div 6 should allow s 115-215 to be simplified considerably: see Annexure B..
	Interest, dividend and royalty income subject to withholding tax	Assessed under Div 11A of Part III of ITAA 1936. Interaction between Div 11A and Div 6 is problematic.		Interaction of withholding tax rules and Div 6 should be made clearer. Amounts subject to WHT in the hands of beneficiaries should be specifically treated as non-assessable non-exempt income for the purposes of Div 6. See suggested redraft of Div 6 in Annexure B.
	IMR income, IMR losses, IMR capital gains, IMR capital losses	Excluded from Div 6: see 4 above.		
	Profits/gains accruing to an MIT	Excluded from Div 6 to the extent that they "give rise to" an amount from which withholding is required is exempt from tax. under Div 6: s 99G of ITAA 1936		Amounts covered by this rule should be clearly identified: see suggested redraft of Div 6 in Annexure B.
	Trust losses	Carried forward for offset against assessable income of future years only if rules in Sch 2F to the ITAA 1936 are satisfied.	Government will "review different options for a more workable approach" to the definition of fixed trust for the purpose of the trust loss rules: Assistant treasurer's Media Release No 155 of 21 November 2011.	Amend definition of "fixed trust" in Sch 2F, s 272-65.
	Distributions of accumulated income and gains previously untaxed in Australia	Taxed as income if distributed to a beneficiary who was a resident at any time in the income year: s 99B of ITAA 1936.		Significant issues arise with the application of section 99B. These issues have also been the subject of judicial notification (refer the comments of Hill J in *Traknew Holdings Pty Ltd v FCT* 91 ATC 4272 where His Honour refers to difficulties with the "extreme width" of section 99B and suggested the provision may need to be read down "having regard to the obvious legislation purpose in exacting it". We consider that section 99B should be repealed and should not be replicated in any amendments to the trust provisions in Division 6. If it is determined that section 99B should be retained: (a) The "application of the corpus exemption to section 99B should be clarified and simplified; (b) The application of the interest

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				charge under section 102AAM where section 99B applies should be reviewed as if can create excessive tax rates where section 99B applies; (c) It should not apply to foreign source income or gains that arose during a period in which the beneficiary was not a resident of Australia.

ANNEXURE B SUGGESTED GENERAL PROVISIONS FOR ASSESSING TRUST INCOME AND GAINS ARISING IN AN INCOME YEAR

As noted in Annexure A, certain types of trust (bare trusts and security trusts, public trading trusts, FHSA trusts, superannuation funds and PSTs) are or should be specifically excluded from the general rules for assessing income and gains of trusts.

For those trusts that are not excluded from the general provisions for assessing trust income and gains, the following model is suggested. As far as possible, the model adopts or mirrors existing concepts in Div 6 of Part III of ITAA 1936, but it eliminates anomalies and inappropriate tax outcomes. It also simplifies interactions between the general provisions for assessing trust income and gains and other parts of the tax law (for example, withholding tax on interest, dividends and royalties, withholding tax on MIT distributions, the IMR rules, the capital gains tax rules and the assessment of franked distributions).

The steps below apply where there are no beneficiaries who are under a legal disability:

1. Calculate the "income and gains" of the trust estate for the income year (ie income and gains as calculated for the purposes of the administration of the trust). This should be clearly defined as the income and gains available for distribution to the beneficiaries of the trust (ie income and gains net of expenses). Gains could include capital gains (which is a change to the existing concept of income of the trust estate) if the trust deed allowed such amounts to be distributed. It would not be necessary for the capital gain to be classified as income of the trust for trust law purposes (as it currently the case), except where a beneficiary is specifically entitled to a capital gain.

2. Calculate the "provisional tax law net income" or "PTLNI" of the trust estate for the income year (ie notional assessable income of the trust estate calculated as if the trust estate were an Australian resident person).

   Note: The trust loss provisions apply in determining whether carried forward losses can be deducted in calculating PTLNI.

3. Allocate specific amounts of PTLNI to each beneficiary in accordance with the present entitlement of the beneficiary to "income and gains" of the trust estate [distributable income or specific entitlement to tax income of beneficiaries] determined under the terms of the trust, as if the PTLNI were in fact the "income and gains" of the trust estate.

   The allocation of actual amounts of PTLNI to beneficiaries would replace the proportional allocation of overall "net income" required under the existing rules. If ~~beenficiaries~~beneficiaries are entitled to shares of specific class of income and/or gains, the allocation of the PTLNI would reflect that entitlement. That is, a "proportionate within class" approach would apply.

   While we consider that the existing concept of present entitlement could be retained as it is well understood, and the extension of the meaning of the term in s 95A of ITAA 1936 could also be retained. However, we consider that any revision of Division 6 should include the following clarification:

   - A beneficiary should be taken to be presently entitled to an amount of "income and gains" if the amount is allocated to the beneficiary in accordance with the terms of trust, this is reflected in the trust's account and the beneficiary receives a financial benefit equal to the amount of the allocated "income and gains" within a reasonable period following the end of the income year;
   - the fact that the "income and gains" is calculated and allocated at or soon after the end of the income year does not prevent a beneficiary being presently entitled to the amount allocated to them; and

- present entitlement need not be determined at the end of the income year or other fixed point in time, but rather by whether the "income and gains" of the trust can be allocated to a beneficiary in accordance with the terms of the trust and distributed within a reasonable time period (eg if the trustee of a discretionary trust allocates distributable income derived during a tax year one month after the end of the tax year and distributes that amount a beneficiary within a reasonable time period, this should not prevent the beneficiary being presently entitled to that income).

For example, say a trust's income and gains (ie distributable income) is calculated as follows:

TRUST "INCOME" NET OF EXPENSES:

Fully franked distribution	$70
Rental income	$100
Interest expenses related to rental income	($50)
TOTAL INCOME	$120

TRUST "GAINS"	$50
TRUST "INCOME AND GAINS"	$170

Note: Some trust deeds include gains in the "income" of the trust. In the example above, the "income and gains" of such a trust would also be $170.

The trust's PTLNI is calculated as follows:

Fully franked distribution	$70
Franking credit	$30
Rental income	$100
Interest expenses related to rental income	$50
Capital gain (eligible for discount)	$50
TOTAL PTLNI	$200

The trust has two beneficiaries (Beneficiary A and Beneficiary B) who are each presently entitled to 50% of the trust's "income and gains". The PTLNI would be allocated to each beneficiary as follows:

Fully franked distribution	$35
Franking credit	$15
Rental income (net of interest expense)	$25
Capital gain (eligible for discount)	$25

TOTAL	$100

If no beneficiary is presently entitled to the gain that accrued to the trust in the income year, the PTLNI allocated to each beneficiary would be as follows:

Fully franked distribution	$35
Franking credit	$15
Rental income (net of interest expense)	$25
TOTAL	$75

The trustee would be assessable on the component of the PTLNI representing the capital gain ($50): see 7 below.

Where franked distributions or capital gains are streamed to particular beneficiaries in accordance with the terms of the trust, the approach currently adopted in section 115-225 to 115-230 of the *Income Tax Assessment Act 1997* should be integrated into the revised Division 6 (rather than operating separately as is currently the case with the temporary measures). That is, capital gains and franked distributions would be allocated on the basis of the beneficiary's proportional share of the trust's "income and gains" unless the beneficiary is "specifically entitled" to a capital gain or a franked distribution, in which case the relevant amount of the specifically entitled franked distribution or capital gain is allocated to the beneficiary.

Following on from the example above, if Beneficiary A was specifically entitled to all of the franked distributions of the trust and Beneficiary B was specifically entitled to all of the capital gains, the amounts of PTLNI allocated to them would be as follows:

Beneficiary A	
Fully frank distribution	$35
Franking credit	$15
Rental income (net of interest expense)	$25
TOTAL	$75

Beneficiary B	
Rental income (net of interest expense)	$25
Capital gain (eligible for discount)	$25
TOTAL	$50

4. In respect of each beneficiary, calculate "actual tax law net income" or "ATLNI" by making the following adjustments to the specific amounts of PTLNI allocated to each beneficiary:

 - exclude amounts of foreign source income derived by the trust estate when the beneficiary was a non-resident;

 - exclude losses incurred when the beneficiary was a non-resident if such losses would have been foreign source income had the losses in fact been income;

 - exclude a capital gain relating to an asset other than taxable Australian property if the gain was allocated to a beneficiary who was a non-resident just before the CGT event giving rise to the capital gain;

 - exclude MIT income if the corresponding distribution of income is subject to withholding tax under the MIT rules;

 - exclude IMR income, IMR losses, IMR capital gains and IMR capital losses;

 - exclude amounts of interest, dividend and royalty income that are subject to withholding tax under Div11A of Part 3 of ITAA 1936; and

 - exclude outgoings and losses incurred in gaining or producing such excluded income and losses.

 For example, following on from the example above, say Beneficiary B was a non-resident at the time the trust made the capital gain and the capital gain does not relate to taxable Australian property. In this case, the capital gain would be deducted from the specific amounts of PTLNI allocated to Beneficiary B (to arrive at Beneficiary B's ATLNI).

4. The whole of the ATLNI allocated to the beneficiary is assessed in the hands of the beneficiary in accordance with its character.

 The revised Division 6 should enshrine the general principle that the specific amounts which make up the ATLNI allocated to a beneficiary retain their character in the hands of the beneficiary and the beneficiary is taken to have derived those amounts directly for the purposes of the income tax law and to be entitled to any tax attributes associated with them (eg franking credits). This should reduce the need to have complex deeming rules (such as Subdivision 115-C which deems a beneficiary to have made a capital gain and Subdivision 207-B to determine when a franked distribution flows through to a beneficiary).

 Trustees would determine whether a capital gain is a discount capital gain but would not apply the discount in calculating the PTLNI and ATLNI. A beneficiary would be told whether a capital gain is a discount capital gain or a non-discount capital gain. For a discount capital gain, the beneficiary would be taken to have satisfied the requirements in Division 115 (given that the trustee has already determined whether the capital gain is a discount capital gain).

5. If the ATLNI allocated to the beneficiary exceeds the actual amount of income or gains allocated to the beneficiary under the terms of the trust, the trustee and the beneficiary can agree (if administratively feasible) that the trustee will pay tax on the excess at the tax rate applicable to the beneficiary. Such tax paid by the trustee will be deducted from (or available as a credit against) the amount payable by the beneficiary.

6. If the beneficiary is a non-resident at the end of the income year, the ATLNI allocated to the beneficiary is assessable in the hands of the trustee as well as being assessable in the hands of the beneficiary. The beneficiary is allowed a credit for the tax paid by the trustee.

 Consideration should be given to allowing a non-resident beneficiary whose allocation of ATLNI has been taxed in the hands of the trustee to treat that payment of tax as finalising their tax obligation in relation to that income. This could be done, for example, by treating the tax paid by the trustee as a final withholding tax (in which case the allocation of ATLNI

is non-assessable non-exempt income of the beneficiary) or treating the trustee's assessment as if it were also an assessment of the beneficiary (to the extent it relates to the beneficiary's allocation of ATLNI). This may attract investment by foreign investors into Australia as it would allow them to obtain more certainty about their Australian tax liability without needing to formally lodge a tax return. Note that this would not be necessary for trusts that only derive income and gains that are covered by the dividend withholding tax, IMR and MIT regimes, as that income would not form part of the non-resident beneficiary's ATLNI.

7. If any of the PTLNI of the trust is not allocated to a beneficiary under step 3, the trustee is assessed on that amount of income according to its character.

The above scheme can readily be adapted to cater for a situation in which one or more beneficiaries is under a legal disability. Essentially, the trustee and not the beneficiary would be assessed on the income under step 4.