Re: Treasury, *Consultation Paper: Modernising the Taxation of Trust Income – Options for Reform* (November 2011)

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This submission is principally addressed to Questions 14 and 15 in the Consultation Paper:

> 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 and appropriate way to reduce the potential effects of the top marginal tax rate applying to unallocated amounts?
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> 15. If a TAD model was adopted, how should the tax law define the concept of a 'distribution'?

1. *Consultation Paper principle 1 ('follow the money' …)*

The shorthand proposition that tax liabilities should 'follow the money' is explained in terms not of payment but of economic benefit: 'in that they should attach to the entities that receive the economic benefits from the trust' (Consultation Paper, section 1.2). A 'present entitlement' as presently defined in the *Income Tax Assessment Act 1936* (ITAA 1936) Pt III Div 6 is an economic benefit because it is a fixed entitlement of the beneficiary, whether presently callable or not. The test is substantially equivalent to one of indefeasibly vested entitlement (s 95A(2)).

The principle of aligning the incidence of tax liability (and, more importantly, the marginal tax rate and fiscal characteristics of the taxpayer so identified) with economic 'ownership' of the taxable income or gain is the real point of the 'follow the money' principle. The Consultation Paper does not suggest that Australia move to a system (such as the US grantor trust rules in 26 USC ss 671-678) which treats a discretionary domestic trust as the economic agent or vehicle of the settlor, grantor or transferor of value to the trust unless substantial distance is put between that person and the allocation or receipt of benefits. The present policy setting generally allows non-personal-services income and capital gains to be allocated through a discretionary trust in a way that is recognised as effective for tax purposes. Economic ownership is addressed at the level of the ultimate benefit rather than its allocation. Taxpayers who use such trusts rely on the current understanding that discretionary allocation of trust income, including the streaming of particular items, to persons with a favourable tax

profile results in economic 'ownership' which is recognised for tax purposes (ITAA 1936 s 101).

2. What would constitute a 'distribution' under the deduction model?

The deduction criteria are critical to the design and effect of the trustee assessment and deduction model described in section 8.3 of the Consultation Paper. Presumably that deduction model is inspired by US trust taxation.

The US deduction rule is in 26 USC 661:

> § 661. Deduction for estates and trusts accumulating income or distributing corpus
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> (a) Deduction.--In any taxable year there shall be allowed as a deduction in computing the taxable income of an estate or trust (other than a trust to which subpart B applies), the sum of--
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> > (1) any amount of income for such taxable year required to be distributed currently (including any amount required to be distributed which may be paid out of income or corpus to the extent such amount is paid out of income for such taxable year); and
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> > (2) any other amounts properly paid or credited or required to be distributed for such taxable year;
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> but such deduction shall not exceed the distributable net income of the estate or trust.
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> (b) Character of amounts distributed.--The amount determined under subsection (a) shall be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income of the estate or trust as the total of each class bears to the total distributable net income of the estate or trust in the absence of the allocation of different classes of income under the specific terms of the governing instrument. In the application of the preceding sentence, the items of deduction entering into the computation of distributable net income (including the deduction allowed under section 642(c)) shall be allocated among the items of distributable net income in accordance with regulations prescribed by the Secretary.
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> (c) Limitation on deduction.--No deduction shall be allowed under subsection (a) in respect of any portion of the amount allowed as a deduction under that subsection (without regard to this subsection) which is treated under subsection (b) as consisting of any item of distributable net income which is not included in the gross income of the estate or trust.

Where trustees have discretion whether to distribute income, the relevant provision is s 661(a)(2); corresponding inclusion in the beneficiary's taxable income is effected under s 662. Unpaid entitlements of beneficiaries are deductible to the trustees if 'properly paid or credited or required to be distributed' for the year in question. US case law on this provision states principles which resemble our present Div 6 jurisprudence, but with the notable exception of ITAA 1936 s 95A(2). A mere book entry in the trust accounts is not enough; an unpaid amount can only be treated as 'credited' and hence deductible if the beneficiary is 'presently entitled' to it, if it is so definitively allocated as to be beyond the recall of the trustee for purposes of further trust accumulation (*CIR v Stearns* (1933) 65 F 2d 371, 373; *Lynchburg Trust & Savings Bank v CIR* (1934) 68 F 2d 356, 359). It must be made available to the

beneficiary, or constructively received in the sense that its non-receipt is really a matter of the beneficiary's own choice (*Lynchburg Trust*, ibid). This is not to say that the current US and Australian jurisprudence and practical outcomes (ex s 95A) are always the same, but the similarity in point of principle is striking.

The proposed deduction model in the Consultation Paper refers to what the concept of distribution 'might' include; it does not positively exclude indefeasibly vested but undistributed allocations although, by not mentioning them, it creates a flavour or actual distribution or payment (section 8.3.1).

The corresponding US position requires distribution or constructive distribution, such that the beneficiary can presently call for payment (*Lynchburg Trust & Savings Bank v CIR* (1934) 68 F 2d 356, 359). That can be compared with the position under Div 6, but for s 95A(2).

Many Australian trusts rely to a significant degree for their working capital on funds which are definitively allocated to particular beneficiaries in a way that satisfies the Div 6 concept of 'present entitlement', but which are retained in the trust. If actual payment were to be required as a condition of fiscal transparency, with the alternative being trustee taxation at the top personal rate, they could face a serious cash flow problem. The problem would be averted by incorporating the substance of ITAA 1936 s 95A(2) into the concept of distribution. In terms of the 'follow the money' principle, s 95A(2) represents a recognition that a vested and indefeasible interest is an 'economic benefit'.

The outer boundaries of deductible distribution could be set at actual distribution, constructive distribution, or indefeasibly vested entitlement. A broad approach reflecting s 95A(2) would accord with the present policy of Australian trust taxation and the concept of taxing by reference to economic benefit.

3. *Notional income under a deduction model*

Notional income amounts have been identified as a particular practical and conceptual problem in Australian trust taxation. The Consultation Paper addresses the question how notional income amounts included in what is presently the s 95 net income of a trust estate might be dealt with under a deduction model. These amounts give rise to differences between the taxable income of the trust and the amount that is available for distribution or allocation to beneficiaries.

The US rules deal with differences between ‘distributable net income’ (which is basically the taxable income of the trust, subject to a few modifications and before any distribution deductions, and is thus functionally equivalent to our concept of s 95 ‘net income’ of the trust estate – but the US concept does not include capital gains, which are dealt with separately) and trust income distributions, etc, which prima facie attract the distribution deduction, in the following way (disregarding the complications of exempt income and transnational situations):

- If distributable net income exceeds prima facie deductible distributions, etc, only the latter amount is deductible to the trustees under 26 USC s 661(a) and taxable to the beneficiaries under s 662.
- If prima facie deductible distributions, etc, exceed distributable net income, only the latter amount is deductible to the trustees under s 661(a) and taxable to the beneficiaries under s 662.

Notional or unreceived (and therefore undistributable) tax-law income would inevitably give rise to tax liability in trustees and would be incapable of flow-through to beneficiaries. The issue does not appear to have the same prominence in US trust taxation that it has in Australia. This may be because the US trust taxation rules apply to a more limited class of trusts than are covered in Australia by Div 6, with business trust generally taxed as ‘associations’.

Under any deduction model, particularly one with highly developed streaming rules, notional or unreceived taxable amounts will results in trustee taxation. This gives rise to different issues, depending on the particular character of the notional income item in question:

- Some unreceived items should clearly be attributable to beneficiaries. This is so, if the item represents an attribute of an actual item that ‘belongs’ to the beneficiary, such as the grossing-up of a distributed franked dividend. The notional amount should travel with the actual amount to which it relates.
- Some unreceived items cannot realistically be dealt with on a current year basis, other than by taxation to the trustees. In that situation, the rate of taxation applied to the trustees and the subsequent fiscal recognition (if any) of the item become critical.

Notional income arises in a wide range of situations, including the imputation credit gross-up (never received by anyone, but corresponding to a real tax benefit attached to franked dividends), attributable income under the various imputation regimes (which may or may not correspond to capital or income receipts in later years), and (arguably) the consequences of enhanced or accelerated capital allowances whereby the profit of an activity is shown as lower in its early years and higher in its later years for tax purposes than for accounting purposes.

The present system strongly prefers single-stage taxation of trust income in the year of derivation by the trustees. This is primarily achieved under ss 97, 99, 99A and corresponding CGT provisions. Full integration under ss 98, 98A and 100 amounts to much the same thing, with s 98 trustee taxation serving as a form of non-final withholding. Section 99B is a backstop for cases that can't be reached by Australian taxation in the year of derivation by the trustees. The s 99A rate is deliberately set at the top personal rate plus medicare in order to eliminate the 'income splitting' advantage that could otherwise be achieved by accumulating unallocated income in an inter vivos trust, which might later be distributed tax free. This is prima facie defensible because, whatever the tax law income of the trust may be, the trust deed can be so drafted and the trust itself so administered that the entire tax burden of a particular year can always be allocated among the beneficiaries by a corresponding allocation of current trust law income. But if we move to a deduction system, bearing in mind that trust taxation applies to trusts carrying on a very wide range of activities, it is inevitable that many trusts will face regular discrepancies between trust law income available for distribution to beneficiaries and tax law income. If the tax law income exceeds what is available for distribution and if the corresponding tax liability falls on the trustees, the options appear to be these:

- Retain single-stage taxation as presently at the top personal rate – this is only justifiable if those notional items that end up being taxable to the trustee are ones that represent active tax planning by individuals on the top tax rate, or are likely to be so small that the applicable rate is relatively unimportant.

- Tax as presently at the top personal rate or at some lower but still substantial rate, and provide for integration between trustee taxation and beneficiary taxation so that, on ultimate distribution, the beneficiary incurs separate tax liability with a refundable tax credit related directly or indirectly to tax paid by

the trustees. This, of course, loses the simplicity of single-stage taxation, though it makes the actual rate of trustee taxation less critical.

- Retain single-stage taxation, but apply a trustee rate which is below the top personal rate though still substantial and which reflects, in a broad-brush way, a fair flat rate of final taxation on trust income. This retains simplicity at the cost of precise progressivity, and thereby departs from strict horizontal equity. If implemented, there would be a question whether the chosen rate should apply to trustee taxation generally in situations corresponding to the present s 99A, in which case there would be an obvious revenue cost and opportunity for tax planning, or whether the rate should be limited to the difference between taxable income of the trust and amounts actually received. (As a matter of design, the comparison could not be between taxable income and trust law distributable income, unless the latter were defined by criteria independent of the terms of the particular trust.) Simplicity favours a single trustee rate. Integrity and protection of the revenue favour a dual rate.

4. Capital gains tax

The greatest anomalies in trust taxation of the past 25 years arise from the poor integration of capital gains and other income taxation. Simple transition to a deduction system will not address those anomalies. If we adopt a deduction model, the relationship between capital gains and other capital income derived by trustees in their fiduciary capacity must be separately considered and addressed.

It should now be accepted that the allocation of tax liability for the taxable income and gains by reference to a single, integrated benchmark is unrealistic and unworkable. If the benchmark is set by reference solely to 'income', it fails to 'follow the money' in respect of capital gains and losses. If it is set by reference to some composite concept, complicated adjustment and reconciliation rules will be required (such as the *Income Tax Assessment Act 1997* Sub-div 115-C and the unavoidably complex streaming rules for trust capital gains) for those many trusts which distinguish between capital and income entitlements. Tax liability for capital gains and for other income derived by trustees should be dealt with by entirely separate charging sections. Trust capital gains and losses should be addressed exclusively within the CGT provisions (*Income Tax Assessment Act 1997* Parts 3.1 and 3.3).