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

By Email: trust_rewrite@treasury.gov.au

Dear Sir/ Madam

SUBJECT: MODERNISING THE TAXATION OF TRUST INCOME – OPTIONS FOR REFORM

CPA Australia represents the diverse interests of more than 139,000 members in 114 countries throughout the world. Our vision is to make CPA Australia the global accountancy designation for strategic business leaders.

Against this background we provide this submission concerning the Consultation Paper issued by Treasury on 21 November 2011 concerning possible reform options in respect of 'Modernising the taxation of trust income'. This submission is made not only on behalf of our members but also for the accounting profession and in the broader public interest.

If you have any questions regarding the above, please contact Mark Morris, Senior Tax Counsel, on (03) 9606 9860 or via email at mark.morris@cpaaustralia.com.au.

Yours faithfully

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ATTACHMENT

MODERNISATION OF THE TAXATION OF TRUST INCOME

The following is CPA Australia's submission in respect of the Consultation Paper issued on 21 November 2011 entitled 'Modernising the taxation of trust income – options for reform'.

1 Introductory comments

CPA Australia welcomes the opportunity to be involved in this consultation process, and view it as a very important opportunity to achieve real, robust reform to the taxation of trust income, as opposed to further tinkering with the existing Division 6 provisions in the Income Tax Assessment Act (1936) ('the ITAA (1936)'). Accordingly such reform should be aimed at making the system easier to comprehend and comply with; resulting in greater productivity.

2 Commencement date

Regardless of the final model adopted, a start date of 1 July 2013 is too soon to enable taxpayers and their advisors to understand and plan for any changes. We submit that a start date of 1 July 2014 is more appropriate, to allow time for full consultation between Treasury and stakeholders, drafting of legislation (including appropriate consultation and potential re-drafting) and education of taxpayers and their advisors.

Particularly if major changes are to be made to the taxation of trust income, such as CPA Australia's preferred model or the Trustee Assessment and Deduction ('TAD') model, a date of 1 July 2014 may be more appropriate.

It is also noted that taxpayers and advisers are only beginning to digest the impact of the interim streaming measures for trusts that took effect for the 2011 year of income. A deferral of the start date will enable a more constructive dialogue, as the experience and knowledge that emerges over time on the effectiveness and practicality of these reforms will be a valuable input into consultation on the broader Division 6 reform process.

An announcement date of 1 July 2013 would be consistent with this as it would give advisers time and opportunity to understand the changes, make necessary preparations and be ready to deal with them by 1 July 2014.

3 Preferred model – Multiple models

CPA Australia's preferred model is to have three separate models for taxing trust income. The three models consist of:

- an attribution model for fixed trusts;
- a flow through model for non-fixed trusts (which would be the default position); and
- an accumulation model for non-fixed trusts (which would be an elective model).

3.1 Fixed trusts

The income of fixed trusts – the definition of which, we submit, is in need of review and extension – would be taxed on an attribution basis, as with the proposed treatment of Managed Investment Trusts.

3.2 Non-fixed trusts

Non-fixed trusts would be divided into 'flow through trusts' and 'accumulation trusts'. Non-fixed trusts wishing to be taxed as an accumulation trust would need to make an irrevocable election to that effect. In the absence of making such an election, the default position is that they would be treated as a flow through trust. In this very important sense, the proposal is to be contrasted to the previously rejected 'entity tax' regime.

(a) Flow through trusts

The income of flow through trusts would be taxed to the beneficiaries of the trust provided it is distributed to them (including by being applied for their benefit or at their direction) before a certain date. The suggested date is the date of lodgement of the trust's return for the relevant year, or 31 October at the earliest. Income not distributed by this relevant date would be taxed to the trustee at the highest marginal rate.

This model should achieve a 'follow the money' outcome.

Under the flow through model, income would retain its character in the hands of the beneficiaries, including but not limited to capital gains and franked dividends. The benefit of the 50% CGT discount and small business concessions would flow through to beneficiaries.

Amounts that are taxable income but not book income would be taxed to the beneficiaries on a proportional basis, unless specifically streamed to particular beneficiaries in accordance with the terms of the trust.

The flow through model would be most suitable and attractive for trusts that hold passive investments rather than businesses. However, some business owning trusts may prefer to use this model.

(b) Accumulation trusts

The income of accumulation trusts would be taxed to the trustee at the business rate of tax, say 30%.

Distributions would not retain their character. This is not a conduit model.

The benefit of the 50% CGT discount would not be available to the trustee (or the beneficiaries on distributions), however, the small business CGT concessions would be applied in the same way they apply to companies.

Distributions would carry a credit for the 30% tax paid by the trustee.

Integrity measures would be required to prevent beneficiaries obtaining the benefit of the trust's income/assets without paying the appropriate amount of 'top-up' tax. These measures could be along similar lines to Division 7A of the ITAA (1936).

The accumulation model would be most suitable and attractive for trusts that carry on businesses and wish to retain income to finance their business. However, some investors may prefer to choose this model, particularly where assets are not held on capital account such that the 50% CGT discount is of no consequence to them.

Importantly, the accumulation model would only apply if the trustee made an irrevocable election that it apply. In the absence of such an election, the default position is the flow through model applies. This means that only those trusts that have made a conscious decision to be taxed on an accumulation basis will be subject to such treatment. This is not equivalent to an entity tax regime as trusts will have the choice of adopting flow through or accumulation treatment. No such choice was provided under the entity tax proposal.

3.3 Reduced complexity

Although this preferred model may appear to lead to greater complexity, given the use of three different models, it is submitted that taxpayers are currently engaging in structuring their business and investments in such a way that leads to greater complexity in practice.

For example, taxpayer groups that use trusts to own and operate businesses seek to achieve a business rate of tax by making unpaid distributions to companies and retaining 70 cents in the dollar to finance their businesses. This has lead to confusion and complexity about the application of Division 7A of the ITAA (1936) to such arrangements and the need to accurately monitor and identify when complying loans and sub-trust arrangements are required.

In addition, taxpayer groups would generally keep their investment assets in a separate trust.

Typically, the existing structure could involve the use of at least four entities; including a business trust, a company beneficiary, a trust to hold the shares in the company beneficiary and an investment trust.

By adopting the preferred model, taxpayer groups could typically reduce the number of entities to two; a flow through trust to hold the investments and an accumulation trust to hold the business.

4 Next preferred model – TAD model

If our preferred model is unacceptable, our next preference is for the TAD model outlined in the Consultation Paper, subject to an appropriate rate of tax being set for trustee assessments.

Factors pointing in favour of the TAD over the other models outlined in the Consultation Paper include:

- it better promotes the ‘follow the money’ guiding principal (although see comments on the difficulty that arises for notional amounts);
- it potentially does away with the current need for determining present entitlement at 30 June each year. We suggest the date by which distributions need to occur should be the date of lodgement of the trust’s tax return, or 31 October at the earliest. If this means some beneficiaries who have already lodged returns are required to amend those returns, it is submitted that this is a better outcome than requiring trustees and their tax agents to rush the

completion of year end accounts and determinations of income and to whom it is distributed; and

- retention of character and source of income.

4.1 Meaning of distribution

As this model is largely based on the concept of a distribution, the term needs clarification.

It is submitted that a distribution should encompass both physical distributions of cash and property as well as applications of cash or property at the direction of or for the benefit of a beneficiary. This should include situations where a trustee applies the distribution by retaining it for the trust's use, pursuant to a loan.

This broad concept of a distribution is similar to the deemed receipt rules for determining derivation of ordinary income contained in sub-section 6-5(4) of the Income Tax Assessment Act (1997) ('the IAA (1997). As such, it is submitted it should be a relatively well understood concept.

Former section 19 of the ITAA (1936) contained a similar concept. There income was deemed to be derived in cases where the money was not actually paid to the beneficiary but was reinvested, accumulated, capitalised, carried to any reserve or otherwise dealt with on their behalf or as they directed. Again, it is submitted this is a familiar concept.

4.2 Tax credit or final tax

We submit that one of the key issues with the TAD model is determining whether tax paid by the trustee will give rise to a tax credit, which is available to beneficiaries on a subsequent distribution of that income, or whether it will be a final tax.

If the tax paid by the trustee is to give rise to a credit, we submit the rate of tax should be aligned with the business rate of tax of 30%. In this case, the benefit of the 50% CGT discount would presumably not be available to the trustee, nor would it be available to the beneficiaries on a subsequent distribution of a taxed capital gain. However, it is submitted the benefit of the small business CGT concessions should apply in a way similar to a company.

We submit that integrity measures, similar to Division 7A of the ITAA (1936), would be required if the rate of tax were in line with the business rate.

If the tax paid by the trustee is to be a final tax, a higher rate than 30% will need to apply but possibly lower than the top marginal rate.

We understand the New Zealand model imposes a final tax on the trustee and that the rate of tax is lower than the top marginal rate. We submit this is something worth investigating.

It is submitted that if the rate for a final tax is to be equivalent to the top marginal rate of tax, the benefit of the 50% CGT discount should be available to the trustee and this should flow to the beneficiaries on a subsequent distribution of the taxed capital gain.

The rate of tax adopted (whether under a credit system or a final tax) should be such that it does not lead to the inefficient behaviours seen under the current system where trusts seek to access the business rate of tax by making unpaid distributions to companies and retaining the funds under loan agreements, resulting in the use of superfluous entities.

4.3 Source of distributions

Another issue is determining whether distributions to beneficiaries are to be treated as coming from untaxed current year income or taxed past year income.

Possible approaches include applying an order or a slice approach.

However, it is submitted the approach used should be easily understood and easily implemented. It should not be focussed on trying to ensure the maximum amount of tax is collected on every trust distribution at the cost of simplicity.

4.4 Notional amounts

A further issue is that the TAD looks at taxing the beneficiaries who receive the economic benefits relating to taxable income. However, in the case of notional amounts of taxable income, there will not be an economic benefit to trace.

The TAD model, as currently proposed in the Consultation Paper, will operate in an inflexible and potentially penal fashion in that such amounts will fall to be taxed to the trustee with no ability to tax them in the hands of beneficiaries at their respective marginal tax rates if that were the preferred course.

The issue is further highlighted where the notional amount is a capital gain that, if assessed to an individual beneficiary might be eligible for the 50% CGT discount. By contrast, if it falls to be assessed to the trustee, the 50% CGT discount would not apply unless the model permits trustees access to the discount on trustee assessments.

It may be possible to address this concern through the adoption of a rate of tax equivalent to the business rate or a final rate that is lower than the top marginal rate. Alternatively, it might be possible to address the concern, at least in the case of notional capital gains, by allowing the trustee access to the 50% CGT discount in cases where the gain is a discount gain.

Examples of notional amounts of assessable income include, but are not limited to, the following:

- Capital gains arising from application of the market value substitution rules to either reduce the cost base (section 112-20 of the ITAA (1997) or inflate the capital proceeds (section 116-30 of the ITAA (1997);
- Capital gains arising when a trust stops being a resident trust – CGT event I2;
- Capital gains arising from various roll-over reversals, such as CGT events J2, J4, J5 and J6;
- Capital gains arising from making an election under section 70-30(1)(a) of the ITAA (1997) when an owned asset starts being trading stock - CGT event K4;
- Capital gains arising from a value shift under CGT event K8;
- Balancing adjustments under section 40-300 of the ITAA (1997) for which market value consideration is deemed;
- Disposals of trading stock outside the ordinary course of a business for which market value proceeds are deemed by section 70-90 of the ITAA (1997);
- Deemed dividends under Division 7A of the ITAA (1936);

- Deemed dividends under the off-market share buy-back rules where the market value substitution rule applies (sections 159ZZZP and 159ZZZQ(2) of the ITAA (1936)); and

- Deemed dividends under section 45C of the ITAA (1936).

This may lead to particularly unfair outcomes in the case of some of the CGT events as they will miss out on the potential of being reduced by the 50% CGT discount (e.g. CGT events I2, J4, K4 and K8).

5 Patch Model

This is our least preferred model.

We submit this model, whilst apparently simple and familiar in that it builds on the existing Division 6, is actually more complex in practice. This complexity is highlighted by the example in the Consultation Paper.

Further, this model does not seize the opportunity for real, robust reform.

6 Proportionate Within Class Model

This model has the positive attribute of being familiar, as it is a variation on the existing Division 6 model in the ITAA (1936).

However, CPA Australia does not believe the model should be adopted as it continues to rely on a framework that has created the difficulties we have seen, such as:

- the concept of present entitlement;

- the need to make beneficiaries presently entitled by 30 June; and

- potential inequities and opportunities for manipulation arising from the proportionate approach.

In addition, it is submitted that this model will see the continued behaviour of trusts making unpaid distributions to companies in order to access the benefit of the 30% tax rate. This results in complexity in the form of additional entities being used as well as difficulties in complying with Division 7A.

Again, it does not seize the opportunity for real and robust reform.

7 Ancillary Issues

7.1 Resettlements

We submit that if a substantial change is to be adopted, such as our preferred model or the TAD model, taxpayers will need to be afforded the opportunity to make amendments to trust deeds in order to ensure those deeds are consistent with the chosen model.

This should be able to be done without fear of resettlement of the trust on a state/territory or federal basis.

7.2 Grandfathering/transitional arrangements

We submit that grandfathering rules may need to be included for existing trusts that have made investment decisions based on the current tax rules.

For instance, if trusts have acquired appreciating assets on the expectation that future capital gains will be eligible for the 50% CGT discount and/or certain treatment under the small business CGT concessions, they should continue to be afforded that treatment regardless of which model is adopted.

7.3 Other provisions

If either our preferred model or the TAD is adopted a review of and amendments will be needed to deal with the interaction of the trust rules and other provisions as noted at chapter 4 of the Consultation Paper.

7.4 Fixed Trust Definition

As discussed, we submit that it is critical that the current statutory definition of a 'fixed trust' be reviewed and amended, so that the concept is considerably broader than is currently the case. The current definition is so limited as to be practically inapplicable. It does not include what would typically be regarded in the commercial world as a fixed trust, such as a unit trust. This position is unacceptable, given the many important tax consequences that attach to the concept of a fixed trust such as those under the trust loss integrity measures in Schedule 2F of the ITAA (1936) and the dividend imputation regime.

7.5 Trust Loss Rules

In addition to amending the definition of a fixed trust, the trust loss rules will need to be reviewed to ensure consistency with the model that is adopted.

It is noted that the trust loss rules already utilise a concept of distribution that is broader than a mere payment or transfer of assets to a beneficiary. Section 272-45 of the ITAA (1936) provides this definition of when a trust distributes income or capital and it extends to cases where the trust reinvests or otherwise deals with income on behalf of the person or in accordance with their wishes.

7.6 Family Trust Rules

It is submitted that the family trust rules have created a great deal of confusion and unintended non-compliance since their introduction. Attempts to amend the rules to permit some flexibility in changing nominated individuals and permitting elections to be varied or revoked, whilst welcomed, have added to the confusion.

Ideally the rules should be simplified and made more flexible, within reason. However, this should not get in the way of the process of adopting a better trust taxation model.

7.7 Section 99B

We submit that if the legislative intention of introducing section 99B of the ITAA (1936) was to deal with distributions of untaxed accumulated foreign income to Australian resident beneficiaries, the section should be amended to make this clear if this section is to be retained under a revised taxation of trust framework. At present, the section appears to apply to any distribution of accumulated income that has not been previously subject to Australian tax.