Submission to

'MODERNISING THE TAXATION OF TRUST INCOME – OPTIONS FOR REFORM'

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KEY POINTS

Trust income should be taxed on the basis that if you receive the economic benefit, you pay the income tax. If you suffer the economic detriment, you get the deduction. This rule should be applied to beneficiaries who effectively earn income and incur expenditure through the actions of a trustee.

In terms of the options set out in the Consultation Paper, my recommendations are closest to a "proportionate within class model". However, I argue that the distribution of trust income should extend to the distribution of associated deductions.

Streaming should be on the basis of a statement made by the trustee specifically for tax purposes, without relying on trust law powers.

1. INTRODUCTION

The taxation of trusts is inherently difficult. This difficulty arises in part from the policy of flow-through taxation, where one person pays tax on another person's taxable income after presumably receiving some financial benefit. The difficulty also arises from the bestowal of "entity" status upon something as amorphous as one person's request to another person to administer their property in a certain way.

Complicated and outdated rules give people wriggle-room to pay less tax than they perhaps should, while prohibiting normal people from understanding the law. In effect, proper taxation – not overpaying it, but not avoiding it either – becomes impossible without paid professional advice.

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2. HOW TO TAX BENEFICIARIES FAIRLY ON TRUST INCOME

Streaming should apply equally to all classes of trust income

The interim streaming rules, found in Division 6E and Subdivision 115-C and 207-B, apply only to net capital gains and franked dividend. The rewritten trust taxation rules should be more generic and apply to all kinds of income, including kinds that do not exist yet. They should therefore deal fairly with exempt and non-assessable income fairly also.

This means that we must distil general principles from the proper treatment of, for example, net capital gains and franked dividends.

This requires us to reflect on a fundamental problem, which is the proper method for taxing beneficiaries of a trust.

Two ways of implementing the flow-through model found in Division 6 are the proportionate method and the quantum method. Each has its own perceived inequities where trust income exceeds or falls below net income due to non-assessed income or non-deductible expenditure.

For the proportionate method, which is the High Court's favoured interpretation of the existing legislation, we have beneficiaries either taxed on something they never received, or avoiding tax on enjoyed real-world economic benefits.

"Flow-through" means making beneficiaries stand in the trustee's shoes

The answer, of course, is that these beneficiaries simply stand in the shoes of the trustee earning the income. Any taxpayer can be left paying tax on income without deducting for entertainment expenses, even though he/she is not able to enjoy that income. Likewise, a taxpayer enjoys a shelter from taxation through depreciation deductions, even though he/she is still in possession of the income.

The tax liability for the assessable income of the trust should follow the economic benefit to which that assessable income is attributable.

In general, assessable income arises from an inflow of economic benefits. This is generally true in the case of ordinary income. Most forms of statutory income are designed to attach a tax liability to an economic benefit, such as a profit, the receipt of property, or access to benefits from a superannuation fund.

Some taxing provisions have a less clear relationship between assessable income and economic benefit. For example, Part IVA includes amounts in assessable income which would have been included had a scheme not been entered into, but which were in fact not. In a similar way, the Controlled Foreign Companies regime in Part X of the 1936 Act include amounts in assessable income which the taxpayer is not necessarily able to obtain. These provisions leave taxpayers paying income tax on amounts not necessarily received. This is a normal part of a modern income tax system.

It may be appropriate to leave such amounts to be taxed in the hands of the trustee. Forms of assessable income that lack direct economic benefits as their basis may not be appropriate for taxation in the hands of beneficiaries. After all, if there is no economic benefit to which the assessable income is attributable, then the beneficiary is not really a beneficiary of it at all. In such a case, the trustee should be taxed at normal rates rather than at a penalty rate.

The existing formulation in Division, that a beneficiary has assessable income in equal proportion to his or her present entitlement to the trust-law income of the trust, needs reform. It should be replaced with a formulation that focuses on economic benefits or financial benefit[1].

"Flow-through" should apply to both income and deductions

Beneficiaries' assessable income should include both income and deductions from the trust. This contrasts with the current treatment, which attempts to collect pieces of the trust's taxable income and make this part of the beneficiary's assessable income.

If streaming was not permitted, then this would not be a problem. However, streaming has been selected as a policy and therefore the deductions problem must be solved.

The existing model of putting the trust's taxable income into the beneficiary's assessable income is problematic because we then need to allocate specific deductions against specific items of income, before "distributing" the net taxable income. It is particularly problematic when some of the trustee's activities are profitable and others incur expenses in excess of income.

It would be better to take flow-through to its logical conclusion and place the beneficiary in the shoes of the trustee. Let the beneficiary take the trustee's assessable income as his/her own, and claim the trustee's deductions as his/her own.

The trust's deductions should be allocated to the beneficiary who is allocated the most closely-related item of assessable income. There should be no discretion for the trustee to choose who gets the deductions. This would enable a trustee disproportionately allocated deductions so as to give one beneficiary a tax-free distribution while giving another beneficiary – say a tax-exempt entity or an entity with losses – a fully-taxed distribution. I would see this as going beyond streaming and becoming abusive.

Some trust deeds contain explicit provisions for allocating expenses against items of trust income. These should not be allowed to be effective for tax purposes. The streaming rules should provide for the steaming of assessable income, and deductions should follow that assessable income. I do not think the policy of streaming is intended to allow deductions to be doled out at will.

Likewise, credits (such as those for franking and foreign tax) should follow assessable income. Trustees should not be able to selectively allocate credits out of proportion to the assessable income to which they relate. If I understand the existing imputation

[1] As defined in section 974-160 of the 1997 Act, and used in section 115-228 of the interim streaming rules.

provisions correctly, this is already the case. A beneficiary obtains a credit by receiving the assessable income to which the credits are attached.

Recommendation

The following principles should underpin the re-written taxation of trust income:

(1) The assessable income of a beneficiary includes part of the assessable income of a trust where the beneficiary has received or is presently entitled to receive the economic benefits to which that assessable income is attributable.

(2) The beneficiary's assessable income is reduced by any allowable deductions of the trust that relate to the assessable income included under (1).

(3) Deductions cannot be allocated to a beneficiary in excess of the quantum of that beneficiary's share of income. That is, the trust cannot distribute losses.[2]

(4) The trustee's taxable income only includes the remaining assessable income and only takes into account the remaining deductions that are not taken on by beneficiaries.

(5) The same dollar of the trust's assessable income or allowable deduction cannot be taken on by more than one taxpayer. That is, an item of income or particular deduction may be split between taxpayers, but there must be no double-taxation or double-claiming.

3. HOW TO LET TRUSTEES STREAM FOR TAX PURPOSES

I recommend that the "streaming" of types of assessable income and the related credits be implemented purely in taxation law, without any reliance on trust law. For example, the trust income tax return form (or a schedule thereto) should allow trustees to specify who gets what in terms of types of assessable income.

This allocation should be effective for income tax purposes regardless of whether the trustee has a particular power to "stream" in equity.

Trust law was not designed to deal nicely with taxation. Trust law has evolved in line with its sole purpose: to ensure that trustees fulfil the duties to the beneficiaries, as directed by the settlor.

You face two significant, related, risks:

(i) that taxpayers will be on uneven footing depending on when and how their trust deeds were drafted; and

(ii) that your streaming provisions will operate in strange ways as a result of the rules of equity and creative trust deeds.

Commentary and discussion following the case of *Thomas Nominees*[3] indicated that trusts can stream income and that beneficiaries can have an equitable right to franking

[2] You would need to decide whether excess deductions should be lost, deducted from the trustee's residual assessable income, or carried forward by either the trustee or the beneficiary.

[3] *Thomas Nominees Pty Ltd v Thomas & Anor* [2011] QSC 417.

credits. On the other hand, interpretations of the *Colonial First State*[4]case indicate that franking credits are nothing and cannot be controlled by a trust deed, as they only exist in the Income Tax Assessment Acts.

The above comments are symptomatic of the fact that trust law is inherently unsettled and subject to endless development. If you build a tax law on the basis that certain things are possible or lawful in equity, then you build on a very unstable foundation.

Taxpayers and their advisers have adapted extensively to the subtleties of the taxation of trusts. Whole business structures are built up around the efficient use of franking credits, tax-free thresholds and access to capital gains tax concessions. Many businesses and investors will be in a position to take advantage of streaming provisions in the tax law.

However, I cannot help but feel concerned that the tax law could reach so far into moulding and shaping taxpayers' affairs. It is contrary to the anti-avoidance spirit that taxpayers should not undertake schemes for no reason other than to obtain a tax benefit.

Settlors should be free to draft their trust deeds to distribute income or property as they see fit, without the need to obtain detailed legal advice on whether "streaming" is permitted and whether the right classes are specified.

Recommendation

The streaming rules, that is, the provisions in the re-written legislation which allocate specific kinds of assessable income and credits to particular beneficiaries, should operate on the basis of a distribution statement made by the trustee for tax purposes.

This distribution statement should, like the existing trust income tax return, set out the identity of each beneficiary and their share of income. In addition, however, it should list the specific kinds of income which each is entitled to.

The streaming rules should only require that the allocation of income to beneficiaries not be contrary to any specific intention of the settlor or the trust deed. Other than that, it should rely exclusively on tax law and not on trust law.

Safeguards

If a settlor feels that the trustee should always distribute a blended stream of income, with different kinds of assessable income distributed to each beneficiary equally, then he/she can state that in a trust deed.

In the case that a trustee truly abuses the power to stream provided by tax law, the generally anti-avoidance provisions in Part IVA can apply. However, streaming is intended to provide efficient outcomes for taxpayers, and there will be little scope to abuse it beyond what was intended.

[4] *Colonial First State Investments Limited v Commissioner of Taxation* [2011] FCA 16.

And in the case that a trustee chooses to stream income in a manner prejudicial to one beneficiary – for example, by allocating them a disproportionate share of an item of assessable income with little economic benefit – that beneficiary would presumably have an equitable remedy against the trustee. It may even be wise to allow beneficiaries the power to challenge the trustee's streaming decisions in court where they are unreasonably prejudicial.

4. ALLOCATION OF INCOME AFTER THE END OF THE INCOME YEAR

It is common practice to complete trustee resolutions distributing trust income after the end of the year of income. It is unreasonable to demand that trustees have their financial affairs for the year finalised on the dot at the 30th of June.

It is more than reasonable to offer trustees a further two months after the end of the year of income to allocate income amongst beneficiaries for tax purposes, and "stream" types of assessable income to them.

I would even argue that trustees should have up until the due date for lodgment of the trust's income tax return to finally determine which beneficiary gets how much of each class of assessable income. After all, the trustee is not in a position to know what classes of assessable income the trust has until he/she has at least partially completed the trust's income tax return.

Trustees may not be in possession of information from third parties, such as statements from managed investment funds, which would allow them to know what classes of assessable income are available.

Recommendation

Streaming and the allocation of income to beneficiaries for income tax purposes should take into account any decisions made by the trustee after the end of the year of income and before the due date for lodgment of the trust's income tax return.

In the alternative, the trustee should be required to make a resolution or determination within the year of income, or within two months of its end, of who the beneficiaries are and what their share of the trust's income – in equitable rather than taxation terms – should be. However, the trustee should be allowed further time to finally determine what kinds of assessable income will be distributed.

5. RESETTLEMENTS & TRUST LOSSES

Trusts should not be able to claim capital losses unless the trust loss integrity rules – which currently only apply to overall tax losses – are met.

From the recent *Clark* case in the Federal Court[5], it appears that the ATO is using "resettlement" doctrines to deny trust's capital losses where the underlying beneficiaries have changed.

The general principle at play is that tax losses, debt write-offs and capital losses all reduce this year's taxable income on the basis of past events. That reduction should only be available if the people benefiting from the reduction today are the same people who suffered the loss in the past.

It is an implicit policy, underlying a number of specific integrity provisions, that tax losses should not be able to be traded. If they could be traded freely, then perhaps a national market would form, losses would be transferred to absorb profits, and income tax would only be levied to the extent that taxpayers profited more than others lost – a net tax on the country's combined profits. But that is not the basis of our income tax.

The principles of resettlement have a place in taxing transactions such as the creation of a trust over property. These principles have application is the income tax context for CGT event "E1", which is when a taxpayer creates a trust over an asset; this is a disposal of something valuable and it makes sense for any increase in its value to be taxed.

However, the application of resettlement doctrines to prevent trustees claiming prior-year losses – as in the recent Clark case – is not the right solution to the problem.

The existing trust loss rules – which appear in Schedule 2F to the 1936 Act – currently do not apply to capital losses. There is no good reason for these rules to apply to some losses and not all.

The problem is that the existing trust loss provisions apply to tax losses overall, after capital losses have already been used to reduce net capital gains that form part of assessable income. Schedule 2F already contains special provisions for debt deductions, which are another special case of an item reducing taxable income by reference to past events. However, there is no provision for denying capital losses.

Recommendation

A "patch" would be adequate in regard to losses. Amend the capital gains tax regime in Part 3-1 of the 1997 Act to refer to the existing tests in Schedule 2F to the 1936 Act, and amend Schedule 2F to the 1936 Act to refer to capital losses as well as tax losses and debt deductions.

You could insert a section after section 102-5 saying something to the effect of,

> *In applying the method statement in section 102-7, disregard a capital loss to the effect that it is denied under Schedule 2F to the Income Tax Assessment Act 1936.*

You could then insert new sections or subsections into Schedule 2F to deny capital losses on the basis of the same tests as overall tax losses. For example, in Subdivision 167-B, you currently have separate sections denying trusts access to tax loss deductions (section 267-20) and debt deductions (section 267-25), both of which refer

[5] *Commissioner of Taxation v Clark* [2011] FCAFC 5.

to the same tests in sections 267-30 to 267-45. You could add a new section 267-27 along the lines of,

> *(1) This section applies to a trust that*
> > *(a) can apply a capital loss against a net capital gain;*
> > *(b) was a non-fixed trust etc*
> > *(c) was not an excepted trust.*
>
> *(2) The trust cannot apply the capital loss against a net capital gain unless it meet the conditions in sections 267-30(2), 267-35, 267-40(2) and 267-45.*

This patch would make it very easy for taxpayers and their advisers to apply the same familiar trust loss rules to capital losses. It would also remove the need to apply "resettlement" doctrines to stop the use of losses.

6. THE RISK OF RETROSPECTIVELY INVENTING A TRUST

The key benefit to a trustee in being recognised as a taxpaying "entity" is that the trust's assessable income and the associated tax liability can be passed directly through to beneficiaries. Currently, however, a trustee can access this benefit even if he/she does not obtain a tax file number and lodge an income tax return until years after the income is earned.

For example, suppose a company buys real property, develops it, and sells it for profit, and does not engage with the tax system at all. It is the Commissioner of Taxation's duty to raise a default assessment to ensure that the company pays tax on its profits. However, there is no way to know whether or not the company is actually a trustee.

Furthermore, even if there was no trust, the company's controllers could retrospectively and fraudulently "invent" one using false documents in order to defeat a tax assessment and push the income tax liability into a more favourable entity.

These considerations are particularly problematic where there are serious risks of non-payment, and the Commissioner may need to quickly issue assessments and act on them by, for example, freezing property to secure payment of the tax. In these cases, where the taxpayer has failed to lodge an income tax return, the Commissioner may not have the option of interviewing the potential trustee and demanding an explanation.

It seems that the Commissioner's only option would be to raise alternate assessments against the potential trustee and against anyone who might be a beneficiary. This is not desirable. People should not be given tax bills simply because they might be beneficiaries of a non-lodging trust.

Clearly, whether or not fraud is present in any given case, it is not good when the Commissioner is prevented from levying tax by the inability to ascertain, without the cooperation of the legal entity receiving income, whether that entity is earning income in its own right or as a trustee.

Recommendation

Where a trustee fails to register a trust with the Commissioner, then the Commissioner should have a discretion to assess the trustee as if it had earned the income in its own right, or as a trustee.

This discretion should be guided by the desirability of levying income tax where it is more likely to be paid, whether that it with the trustee or the beneficiary. Such a discretion would be, in effect, a penalty to encourage trustees to register their trusts.

Where a trust was not registered due to a mistake – for example, because the trustee did not realise that a trust had resettled, and so had not registered the new trust – there should be an exception to the discretion and the trustee should have the opportunity to register the new trust.

An exception could also be provided for simple cases such as bank accounts clearly labelled as being held by one person as trustee for another person. Parents may have these kinds of accounts to build savings for their children's future, and they should not necessarily have to register these as trust entities. They could simply ensure that the interest earned on the account is reflected in the children's income tax returns as if it were their own income.

7. TIMING ISSUES, PARTICULARLY CHANGES IN BENEFICIARIES

Assessable income does not always arise in the same year of income as the economic benefits to which it is attributable.

For example, a trustee might have an asset that has increase greatly in value. The trustee might also have the power to borrow money against the trust property. The trustee could conceivably borrow against the increase in the value of the asset in order to make regular cash payments to a beneficiary to support their lifestyle.[6]

However, the assessable income attributable to that increase in asset value does not arise until the asset is realised and a capital gain is recognised. At that point, under the existing Division 6, the assessable income must be allocated to a beneficiary in receipt of trust income in the year of realisation. The beneficiary who enjoyed the economic benefit may not even be a beneficiary anymore.

Recommendation

Therefore, you should consider whether the re-written tax legislation should allocate that assessable income to the former beneficiary who received the economic benefit, even if they are not currently a beneficiary.

This would require that the beneficiary carefully account for the future tax consequences of their receipts from the trustee, even if they are not taxable at the time

[6] Clearly this is not sustainable long-term, but could be done over a few years in a trust that had other income streams or had temporary cash-flow problems.

of receipt. The beneficiary may not be equipped for this administrative burden. It may be wise to institute a Pay-As-You-Go Withholding system so that, where a trustee provides a pecuniary benefit out of a source that will be assessable in a later income year, the trustee withholds an amount to account for the future tax liability.

8. DIFFICULTY OF "REDEFINING" THE INCOME OF THE TRUST ESTATE

One of the options in the Consultation Paper was to statutorily define the phrase "income of the trust estate" as it appears in section 97 of the 1936 Act. This would not work because a beneficiary cannot be "presently entitled to" anything other than the income of the trust estate as defined by equity and the trust deed.

When the trustee of a discretionary trust makes a resolution to appoint income, or even specific kinds of income, to a beneficiary, that beneficiary receives a share of the "income of the trust" as defined by equity and the trust deed.

Suppose you defined the income of the trust estate to mean "net income of the trust", or "ordinary income", or accounting profit. You would be left with a section 97 that apportioned assessable income on the basis of "present entitlement" to the chosen concept of income. But you are left with a problem: to what extent is a beneficiary "presently entitled to" a tax or accounting concept?

Redefining "income of the trust estate" does not work, even as a "patch", unless the whole mechanism of section 97 is reformed.

Furthermore, it is not recommended to attempt to define income for trust law purposes. This would unfairly prejudice all existing trusts, which may have many years to run, with an unforeseen change to how the settlor's intentions will be carried out.

This submission is written in a personal capacity and does not reflect the views of my employer or anyone else.