

10 February 2012

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

Dear Sir

**Modernising the Taxation of Trust Income
Submission to Consultation Paper**

We thank you for the opportunity to provide our submission in relation to the *Modernising the Taxation of Trust Income Consultation Paper*.

We continue to support the Government's initiatives to improve the taxation laws with respect to the taxation of trusts and take this opportunity to provide our comments relating to some of the matters raised in the Consultation Paper. We have not sought to comment on all issues raised in the Consultation Paper but have limited our discussion to the matters most salient to our clients, which generally include family groups and high net wealth individuals.

1. Amended Assessment of Trusts

Under section 170 of the *Income Tax Assessment Act 1936* ("ITAA 1936"), the Commissioner may generally only amend an assessment within a limited period after the day on which the Commissioner gives the Taxpayer notice of the assessment. In relation to trusts, the Commissioner's administrative practice has been to not issue any notice of assessment to trustees of a trust estate in respect of nil assessments. This means that the Commissioner may technically have an unlimited period to amend the assessments of most trust tax returns.

We are greatly concerned with such wide powers of amendment conferred on the Commissioner and the uncertainty that this creates for taxpayers. The problem arises due to a technicality. As the Commissioner chooses not to "give notice" in respect of nil assessments to trusts, the limited amendment period arguably never commences.

In respect of certain taxpayers (but not for trusts), section 166A of ITAA 1936 currently deems the Commissioner to have made, notified and served an assessment (including nil assessments) at the time when the taxpayer furnishes its income tax return. We believe the current problem could be addressed simply by extending the provisions in section 166A to trustees of a trust estate.



2. Determining Present Entitlement by Year End

The current legislative requirement to determine present entitlement to distributable income of a trust by 30 June is inflexible and creates administrative impracticality as well as an additional compliance burden to taxpayers.

We recommend that this issue is addressed by legislative amendment to specifically allow a trustee of a trust estate to determine present entitlement at a time later than the end of the income year. We would suggest that the determination of present entitlement should be legislatively extended to the time that the trust tax return is due to be lodged.

As a matter of tax principles, we do not see any reason why there needs to be a limited time for present entitlement to be determined earlier than the time that the trust tax return is due to be lodged (subject of course to the terms of the trust deed). In fact, many choices and elections that are permitted under the Tax Acts generally enable the taxpayer to make that choice by the time the tax return is due (for example, elections and choices in Pt-3-90 of ITAA 1997 in relation to tax consolidation, Division 152 of ITAA 1997 in relation to small business concessions and Pt 3-1 of ITAA 1997 in respect of the capital gains tax regime). Trusts should not have to suffer the administrative impracticality of having to determine present entitlement before the trust returns are due to be lodged.

3. Character Flow-Through and Streaming

We welcome the recent legislative amendments which confirm that capital gains and franked distributions can be streamed to particular beneficiaries. However, we do not see any basis for limiting the ability for a trust to stream only franked distributions and capital gains but not any other classes of income. Instead, we believe the conduit theory of trusts should be adopted in its entirety.

Trusts are commonly used as a vehicle to accumulate wealth through a variety of investments which are not limited to Australian company shares and other capital assets. Trusts often derive other classes of income such as interest income, rental income, foreign income and trading income. In addition, trusts may also derive other amounts such as exempt income, and non-assessable non-exempt income. It is common for trust deeds to include powers to allow the trustee to distribute particular classes of income to particular beneficiaries.

We therefore submit that any reform to Division 6 of the ITAA 1936 should include rules to ensure character retention of all amounts in the hands of a trustee when distributed to beneficiaries.

4. Under and Over Distributions

In its *Review of Taxation Arrangements Applying to Managed Investment Trusts, Report to the Assistant Treasurer* (Aug 2009), the Board of Taxation recommended options to deal with under and over distributions (see Chapter 8 of the Report). The rationale for this is that under the current laws, where a trustee of a trust has made an error in distributing amounts to beneficiaries, to correct the error may then require beneficiaries to seek amendments to their tax returns, which lead to compliance costs for trusts, their beneficiaries and administration costs for the ATO. Accordingly, the Board proposed, and the Government has agreed to implement, rules to enable under or over



distributions to be carried forward to the following income year, subject to a de minimis of 5% of the net income of the trust.

While managed investment trusts that are widely held have significantly more beneficiaries than most other trusts, the scope for error in distributing trust income, often due to circumstances outside the trustee's control, and the administrative burden in correcting such mistakes apply the same to all trusts. We therefore recommend that proposed rules relating to under and overs should not be limited to managed investment trusts and should be extended to all trusts.

5. Trustee rate of tax

Under current rules, net income of the trust that has not been distributed to beneficiaries is effectively taxed to the trustee at the highest marginal tax rate. Division 6 effectively "forces" trustees to distribute all income to beneficiaries. In order to avoid taxation to the trustee at the highest marginal tax rate, corporate beneficiaries are often used to shelter any excess trust income at the corporate tax rate.

This inevitably leads to greater complexity in trust structures and additional administrative burden for taxpayers and the ATO. The ATO's controversial change of attitude towards unpaid present entitlements to corporate beneficiaries and Division 7A has further increased the complexity and uncertainty relating to the use of trusts (see, for example, *Practise Statement Law Administration* PSLA 2010/4).

We believe that the need for corporate beneficiaries as part of a trust structure, and the recent difficulties associated with using them, could be entirely eliminated if the rate of tax imposed on undistributed trust income were reduced to equal the corporate tax rate. Trustees would no longer be required to distribute all income of the trust to beneficiaries and could more readily retain funds in the trust.

For the avoidance of doubt, we are not advocating entity taxation. Trusts should continue to be taxed as a flow-through. Our recommendation is for a reduction of the trustee rate of tax to enable trustees the flexibility of retaining income of the trust which is then subject to the corporate tax rate as opposed to the highest marginal tax rate under the current regime.

We believe that such an approach can work in conjunction with the trustee assessment and deduction model (discussed further below).

We would also envisage that undistributed trust income that has been taxed to the trustee at the corporate tax rate could be distributed in subsequent income years to beneficiaries with credits for tax paid by the trustee attached as a credit. For these purposes, a concept similar to a franking account could be introduced.

6. Patch Model

We are not in favour of the patch model. Our main concern is that the current rules under Division 6E of Part III of the ITAA 1936 is inordinately difficult to apply and we recommend its removal. While we applaud the Government's attempts to confirm the streaming of capital gains and dividends



through trusts, the rules introduced under Tax Law Amendment (2011 Measures No.5) Bill 2011 are overly complex and our only solace is that they were intended to be interim measures.

As we have discussed above, we believe the new trust regime should include a general rule of character flow-through of all amounts and should not be limited to capital gains and dividends.

7. Proportionate within Class Model

In principle, the proportionate within class method can achieve the objectives of the current review. As stated in 8.2.5 of the Consultation Paper, this model provides a better basis for determining character flow-through and the potential for streaming of various classes of income.

Our concern with the proportionate within class model is that the rules would be rather complex and, similar to our concerns with the patch model, we would envisage the legislation introducing such rules to be difficult to apply. The adoption of this model would still require trust concepts of “present entitlement”, “income of the trust” and “distributable income” to be applied. Furthermore, there also needs consideration of whether losses of one class can be offset against income of another class. We would be strongly against any concepts of loss quarantining within classes.

8. Trustee Assessment and Deduction Model

This is our most favoured approach.

Conceptually, it is easy to understand and can be relatively simple to apply. We believe this model best achieves the objectives of the review, particularly as there is less reliance on the interaction of trust law concepts, which, in our opinion is the reason for much of the complexity.

We favour the concept of deductible distributions as being a distribution of actual cash or property to a beneficiary or an application of cash or property for the benefit of the beneficiary (i.e. an unpaid present entitlement). In line with our comments above, we recommend that the time for this to occur should be at or before the time when the income tax return for the trust falls due. We further agree that the deductible distribution should incorporate certain amounts such as tax offsets which are able to be streamed to particular beneficiaries. There should also be a general rule of character and source retention for amounts distributed to beneficiaries (i.e. not limited to capital gains and dividends).

We strongly recommend, however, that the trustee assessment and deduction model should be accompanied with a reduction of the trustee rate of tax to equal the corporate tax rate.

In addition to our reasons stated above, as the scope for trustee assessments is greater under this model, it would be incongruous for the trustee to suffer taxation at the highest marginal tax rate where there are undistributed amounts.

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We thank you for the opportunity to provide our submission.

Should you have any queries or require further specific comment, please do not hesitate to contact the writer.

Yours sincerely

DANIEL ALLISON & ASSOCIATES
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