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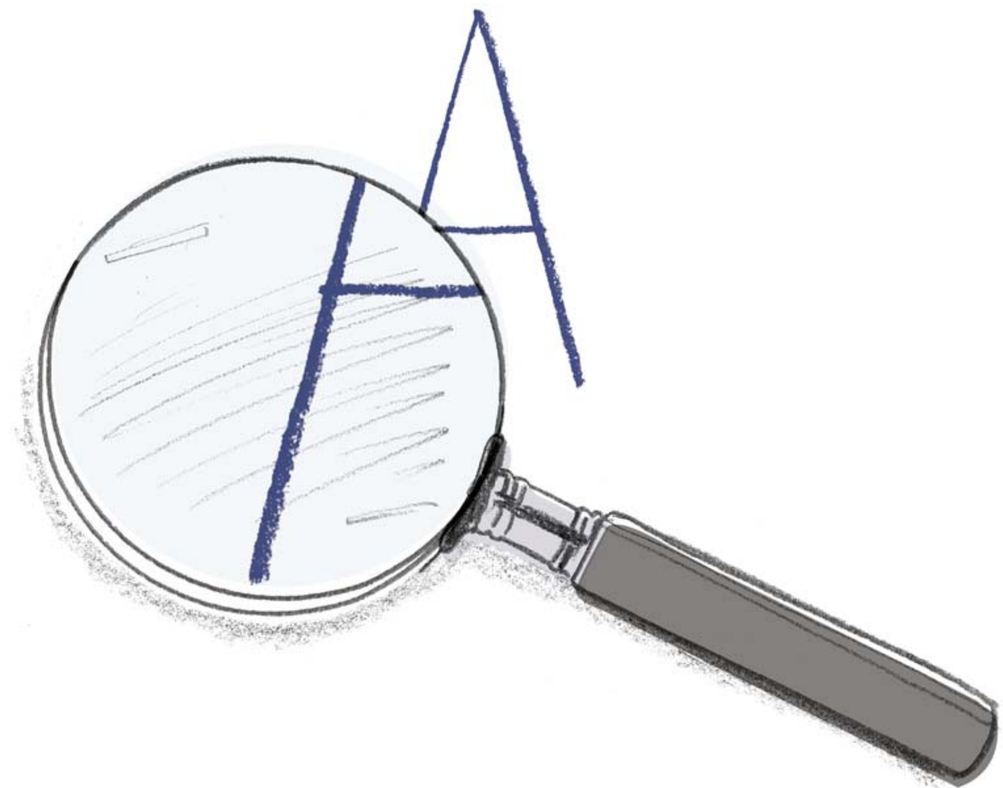
Modernising the taxation of trust income

February 2012



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16 February 2012

Dear Sir/Madam

SUBMISSION – MODERNISING THE TAXATION OF TRUST INCOME

Grant Thornton Australia Limited (Grant Thornton Australia) appreciates the opportunity to provide comments to Treasury on the Consultation Paper "Modernising the taxation of trust income" dated 21 November 2011.

Grant Thornton's response reflects our position as leading advisers to family groups and privately held companies and businesses as well as to smaller firms assisting that sector.

Our response comprises our submission regarding the model for trust taxation together with responses to the specific questions posed in the Consultation Paper.

Trusts are complex enough without compounding taxation complexity

Trusts are dynamic vehicles that continue to evolve with the increasing complexity of today's business and investment environment. They are complex structures before considering taxation issues. The past 30 years and more of case law has illustrated the myriad of taxation issues that trustees and their advisers need to consider.

Legislative reform over that period has only further complicated these issues. While the introduction of capital gains tax is often quoted as the source of many problems with trust taxation, many other examples can be proffered. The most recent reforms from 30 June 2011 to "patch over" supposed problems arising from the *Bamford* High Court decision themselves significantly increased trust complexity; we would say needlessly.

Trusts are set to remain a feature of Australia's business and investment landscape, especially as our economy tackles the challenges of boosting productivity and wealth despite an ageing population and workforce. This Treasury review should take the opportunity to ensure that trust taxation laws facilitate rather than hinder the approach to these challenges.

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To this end, the outcome of the review should:

- reduce complexity so that trustees can operate their trusts with affordable compliance costs
- maintain the flexibility of trusts as a vehicle for wealth creation and accumulation
- ensure that interactions between trusts and beneficiaries are not so cloaked by taxation considerations as to make trusts inflexible and practically unworkable
- provide certainty so that trustees and beneficiaries have confidence in the outcomes of decisions made

In particular, the current policy of taxing most trustees at penal rates and denying them privileges (eg refundable tax offsets and CGT discount) should be abandoned. A policy that causes trustees to take an "all or nothing" approach and focus on tax issues disproportionately is at odds with the object of creating wealth, thereby reducing the effectiveness of the tax system, and is an obstacle to efficient tax administration.

The Grant Thornton model for trust taxation

Our favoured approach to trust taxation is based on the Trustee Assessment and Deduction ("TAD") Model outlined in the Consultation Paper – that is, that assessable income should be taxed in alignment with the benefits enjoyed.

The model should have the following key features:

- a trust's taxable income should be assessed to the trustee, after deduction for amounts assessed to beneficiaries
- beneficiaries will be assessed on the basis of amounts distributed from the trust within ten months of year end (two months for widely held trusts if taxed via Division 6). The assessed amount will be based on the ratio of amounts distributed to amounts retained
- if the trustee has streamed any class of income or gains, this approach will be applied within that class for the year that the income or gain is generated
- beneficiaries will be assessed at their own tax rates. They will enjoy their share of tax offsets generated by the trust. A beneficiary's capital losses will continue to be absorbed in the current manner by the relevant share of a trust's capital gain. Discount capital gains will continue to be adjusted in accordance with the beneficiary's entitlement to the CGT discount
- a distribution will arise when amounts are paid to or applied on behalf of a beneficiary. Merely conferring a present entitlement will not be a distribution

- it is counter-intuitive and unproductive to tax a trustee at penal rates and reverse tax benefits on retained taxable income while the trust still has the economic benefit of the funds and is still applying them productively. The trustee tax rate should be aligned with the corporate tax rate (currently 30%) which is consistent with the dominant corporate beneficiary approach applied administratively. The capital gains discount should be preserved irrespective of retention

- amounts distributed in later years will give rise to beneficiary assessable income. As further amounts are distributed, assessable income will arise on a pro rata basis and they will enjoy a pro rata tax offset for blended credits available within the trust, comprising trustee tax paid and tax offsets enjoyed by the trustee for the relevant year. No streaming will apply in later years

This submission discusses how we propose this model will operate in practice.

This model for trust taxation is focused on private trust estates. Consideration should be given to excluding from the model bare trusts and other trusts where beneficiaries have an absolute entitlement. The approach should not apply to charitable trusts as they distribute their income to tax exempt bodies. Consideration should be given to exclude widely held trusts currently taxed under Division 6 altogether, or at least provide them with an election to be taxed via the Managed Investment Trust regime. Also, while the model should work successfully for deceased estates and testamentary trusts, further consultation is needed to ensure that the many issues affecting such entities are accommodated.

Finally, we encourage a simplification of the very complex trust loss rules and also to rationalise the operation of section 99B. The latter provision should not apply in a domestic setting; whether and how it should apply for cross-border trust distributions needs re-assessment as part of the review of the taxation of foreign income.

Should have any queries in relations to these matters please contact me on paul.banister@au.gt.com or 07 3222 0202.

Yours faithfully
GRANT THORNTON AUSTRALIA LIMITED

Paul M Banister
Partner – Tax

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About Grant Thornton

Grant Thornton Australia is a single national firm with offices located in Sydney, Melbourne, Brisbane, Perth and Adelaide.

Grant Thornton Australia has over 90 Directors and 724 staff in the areas of Audit and Assurance, Privately Held Business, Wealth Investment Management, Tax and Specialist Advisory Services (which includes Corporate Finance and Recovery & Reorganisation).

We represent a very significant client base of closely held business and investment entities in Australia. This core client base makes use of many types of trust structures and we are accustomed to advising on the wide variety of commercial and compliance issues that arise when managing and operating such structures.

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Grant Thornton's model

The model to reform trust taxation should be one where the taxable income of a trust is assessed to those that enjoy the economic benefits related to that taxable income. This is akin to the philosophy underlying the proposed TAD model. The chosen model should:

- reduce complexity so that trustees can operate their trusts with affordable compliance costs
- maintain the flexibility of trusts as a vehicle
- ensure that interactions between trusts and beneficiaries should not be so cloaked by taxation considerations as to make trusts inflexible and practically unworkable
- provide certainty so that trustees and beneficiaries have confidence in the outcomes of decisions made

Achieving these objectives is not only necessary for trustees and beneficiaries. The current state of confusion puts many skilled advisers we deal with in the position where they need to obtain expert advice on what should be straight forward trust operational matters, which increases compliance costs and places undue pressure on business advisers.

The information below explains how the model should work, after which further comment is provided on some notable matters.

How should the model work?

Who should be assessed?

Beneficiaries should be assessed on the taxable amount that relates to the economic benefits they enjoy. The trustee should be assessed on the balance.

What should be assessed?

A trust's taxable income, which should be calculated as it is currently determined.

When should beneficiaries be assessed?

Beneficiaries should be assessed on current year income if they have received a distribution from the trust within ten months of year end or the trust's return lodgement date, whichever is the sooner.

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For widely held trusts currently taxable via Division 6, distributions within two months of the year end would be assessed. The Government may consider an exclusion or opt out for such trusts as an alternative.

What should they be assessed on?

Beneficiaries will be assessed on a share of the trust's taxable income.

In the year of income, the trust's combined distributed income and distributed capital gains will be compared with the total income and capital gains generated by the trust. The resulting ratio will be applied to the trust's taxable income to determine the assessable amount to be allocated to beneficiaries.

Where income and capital gains are separated into classes, this approach will be done by class.

In subsequent years, beneficiaries will be assessed on the same basis as distributions are made, but with a refundable offset for "blended" tax credits remaining within the trust, ie tax paid by and offsets previously applied by the trustee in relation to that year. No streaming will be permitted, ie each later year distribution will deal with the classes of income and gains on a pro rata basis.

What is a "distribution"?

A distribution will arise when an amount that relates to taxable income is paid to or applied on behalf of a beneficiary. Non-commercial loans, payments and debt forgiveness in favour of a beneficiary or their associate would also be regarded as a distribution.

Conferring a mere present entitlement on a beneficiary will not be sufficient for a distribution to arise. More positive action such as making an actual payment is required.

That is, the trigger for taxing a beneficiary is based on economic benefits received rather than the equitable concept of present entitlement to income, as extended in meaning by Division 6. Also, as distributions of both income and capital gains in the new model may trigger a tax liability, the current approach would be ineffective as it focuses on "income of the trust".

How is the trustee taxed?

The trustee will be assessed on the trust's taxable income less a tax deduction for amounts assessed to beneficiaries.

Any tax offsets not allocated to beneficiaries would be available to the trustee. Unused offsets should be dealt with in the way currently applied to individuals (eg excess franking offsets to be refundable, excess foreign income tax offsets to be lost).

The CGT discount should be preserved whether or not all income and capital gains are distributed.

What is the trustee's tax rate?

The trustee's tax rate will be the corporate tax rate (currently 30%).

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In this way, the rate is aligned with the rate currently applying for the large number of trusts that confer present entitlement on, but defer actual distributions to, associated private companies.

What safeguards are needed?

Taxing the trustee on retained income at a different rate to beneficiaries provides an opportunity for retention of income for the long term and also perhaps an avenue for abuse. This is overcome by distributions in subsequent years "shifting" the taxable income progressively to beneficiaries to be taxed at their marginal rates as retained income and gains are distributed.

The justification for taxing the trustee on retained income is that the trustee should be taxable if they still enjoy the economic benefit of using the funds. This involves two main risks: that beneficiaries will enjoy the economic benefit of retained income before a distribution arises, and that tax revenue will reduce if trustees are permitted to retain income without a looming threat of a section 99A penal assessment.

The former risk is mitigated by including, as a distribution, the value of any non-commercial transactions with beneficiaries or related parties in a similar way to Division 7A.

In relation to the latter risk, we have considered complementing this approach by deeming a distribution or taxing the trustee in some form after a maximum retention period (say 10 years). However, we have rejected the need for such a safeguard.

Why are these safeguards suitable?

It is rare for a section 99A assessment to arise across the whole of our extensive client base. Accordingly, we reject the need to impose a penal rate on the retained income and gains of trustees so as to protect tax revenue that effectively does not exist.

And while we acknowledge that the current system does promote the conferring of present entitlement so that 100% of taxable income is assessed to beneficiaries, the current system falls far short of imposing the top marginal rate on taxable income derived by trusts. The dominant mode of taxation of trust income in Australia today is to tax:

- beneficiaries on income they enjoy, via distributing enough to them to ensure that they do not overdraw their beneficiary entitlement accounts;

- a family company on the balance, which effectively represents funds retained in the trust for its further investment

The outcome is that, usually, no more than 30% tax applies on retained taxable income and marginal rates apply on what is distributed. So broadly we consider that our proposal would only give rise to a minor risk to tax revenue, if at all.

Conversely, our proposal may benefit the revenue. A problem with the current system is that the prescriptive manner in which the supporting integrity provisions (ie Division 7A) operate provides timing opportunities so that at least one year's delay in individual assessment applies in most cases.

Our proposal of allocating the tax burden to beneficiaries on the basis of "distributions" arising up to 10 months into the next tax year should mean that, in some cases, beneficiary assessable income will arise earlier than under the current system.

As noted above, we have rejected the need to impose a timeframe on trustees to distribute all income and gains. Current administrative policy is to support the many trustees with unpaid present entitlements to associated private companies. For example, two of the three options available in Law Administration Practice Statement PS LA 2010/4 provide an extended time for payment (7 years in one case; 10 years in the other). The other solution involves a potentially unlimited timeframe.

While such a policy could be enshrined in the law for trusts retaining income and capital gains, we have concluded that this could not be achieved without creating further complexity, compliance costs and administration. Any time period chosen would need to accommodate trustees leaving profits invested productively and for a relatively long term, in line with current administrative treatment. However, imposing any time limit would require trustees and tax administrators to maintain year-by-year records of undistributed profits, undistributed taxable income and undistributed tax credits – and then have some mechanism to decide in which year each separate distribution is to be allocated. Imposing a time limit may also give rise to the need to dispose of assets at unproductive times.

The timeframe is also considered unnecessary as, unlike the current Division 6 which focuses on present entitlement to income only, the new model responds to actual distribution of both trust income and capital gains where they have affected taxable income. To require the distribution of a trust's capital base would impose an unreasonable burden on trusts and their stakeholders, especially as some trusts are unable to distribute its capital until the vesting date.

For the basis of taxing a trustee to be valid, the model also needs protection from non-commercial transactions with beneficiaries or related parties. This protection will occur by deeming a distribution for non-commercial loans, payments and debt forgiveness. However, given that many trusts customarily lend to related parties, an exclusion should apply for beneficiary and related party loans repayable on commercial terms, for example on a basis similar to a Division 7A excluded loan. The trustee retains the economic benefit of the funds involved in such transactions so such an exclusion is appropriate for the model. This also facilitates ongoing family dealings in many taxpayer groups and prevents a tax burden arising on funds that are intended to be repaid and perhaps later distributed to different beneficiaries.

Why does this approach meet the review's objectives?

This model achieves each of the principles outlined in Section 1.2 of the Consultation Paper, namely:

- the tax liability "follows the money", that is tax arises where the economic benefits of trust income is enjoyed – initially on the trustee and later on the beneficiaries

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- the model is conceptually robust as it is simple (eg relies on there being a "real" distribution rather than the illusory concept of "present entitlement"), has realistic scope (eg the tax burden relies of the flow of all funds giving rise to assessable income rather than simply "income of the trust estate") and is supported by important safeguards (eg a tough definition of "distribution")

- the model is devised to minimise compliance costs and complexity. It provides as much certainty as is reasonable in the context of trust law

- it is clear that the character and source of the funds is to be retained as they flow-through to beneficiaries

- trust losses are still to be applied within the trust incurring the loss alone. We encourage simplification of this important area, one worthy of a consultation review itself

Broadly, the model should also be fiscally neutral.

The further comments below elaborate on some issues arising from our proposed model.

Trustee tax rate

Aligning the trustee tax rate and the corporate tax rate will eliminate the issues and uncertainty around Division 7A and unpaid present entitlements ("UPE's") to corporate beneficiaries. This is because, in the majority of cases, there would be no need to shelter income in a beneficiary company to obtain the benefit of the corporate tax rate. The reduced reliance on corporate beneficiaries will simplify tax administration and minimise compliance requirements of Australian taxpayers.

Imposing a trustee rate no greater than the corporate tax rate is crucial to the operation of this simplified trust model. As discussed above, a trustee rate which does not exceed the corporate tax rate reduces the need for UPEs to corporate beneficiaries while simplifying the trust taxation system.

Other than the greater simplicity and reduced compliance costs, this approach enables trustees to administer trusts to benefit the wealth generated on behalf of beneficiaries rather than needing to put tax issues first.

The approach of taxing the trustee on retained income and capital gains also provides trusts with an opportunity to better deal with the effect of timing differences that arise from time to time.

Time limits for current year distributions

Our model provides that, to the extent that distributions are made to beneficiaries within 10 months of year end, the beneficiaries will be assessable rather than the trustee. For widely held trusts, if still taxed under this model, the period will be 2 months.

The duration of the period should be long enough that it avoids the needless compliance and administration involved with taxing the trustee on profits that will be distributed relatively soon after year end and also reduces the risk to revenue of tax deferral opportunities when beneficiaries are intended to enjoy the economic benefit of trust profits during the next year.

For most private trusts, a maximum period of 10 months should suffice, which is in line with tax agent lodgement deadlines. However, the period should cease on the lodgement date for those trusts that lodge their returns inside the 10 month period.

For widely held trusts that are taxed under Division 6, a shorter period is required to facilitate administration. We have specified a 2 month period.

Mechanics of assessment in later years

Where the trustee is assessed in the current year of income, they will be assessed on a residual basis. That is, the trustee is assessed on whatever taxable income of the trust that is not taxed to beneficiaries. Against this tax, the trustee can claim offsets that are not allocated to beneficiaries, whether by streaming or not.

At the end of the income year, trustees will need to apply undistributed amounts to three accounts:

- undistributed income and capital gains account, comprising the combined total of trust income and taxable gains not distributed in the year

- undistributed taxable income account, comprising the trustee's taxable income (that is the amount of the trust's taxable income that is not assessed to beneficiaries in the year)

- undistributed tax credits account, comprising the total of trustee tax payable for the year and tax offsets applied in calculation of that tax payable

The intention of this approach is to confirm the amount of undistributed income and capital gains and to establish a basis to allocate taxable income and tax offsets as distributions occur in future years. The practical effect is that tax credits will be at a blended average rate irrespective of how future distributions are made and whether or not streaming occurred in the original year of income.

If a distribution is made in a later year, trustees will need to determine whether the distribution is allocated to the current year or from the prior year undistributed pool. If the latter or if no resolution is made by 10 months after year end (or the return lodgement date if earlier), then the distribution will be deemed to occur from the earlier year. The undistributed income and capital gains account will be debited until that account is exhausted.

If desired, the taxable income account itself may be broken into the original character and source of foreign income, taxable capital gains and other income so that the beneficiary's tax treatment of any foreign income tax offsets and personal capital losses is consistent with current law. Whether to proceed with this aspect requires a balancing of whether the increased complexity can be justified to preserve revenue neutrality and respect of current rules.

The consequences of debiting a distribution against the undistributed income and capital gains account will be:

- a pro-rata amount of taxable income will arise for any beneficiaries receiving the distribution
- a pro-rata amount of tax credits will arise for those beneficiaries
- a debit will arise to the undistributed taxable income account
- a debit will arise to the undistributed tax credits account

It is acknowledged that this approach creates new tax compliance and administration requirements. However, any solution to taxing trusts is bound to involve some complexity. The approach above is similar to record keeping requirements currently imposed administratively on the many trusts with UPEs for related private companies. The advantage over the current regime is that, overall, the model is much simpler.

Use of Division 7A concepts

Reforms need the support of integrity measures. To reduce transition, administration and compliance costs, the concepts of the existing Division 7A should be utilised for the new trust model. These concepts are relatively well understood by the taxpayer community, except for certain trust concepts. The new model described in this submission should overcome the latter.

Streaming

Trusts with the ability to stream classes of income and capital gains, subject to the trust deed, should retain this ability without limit. To do otherwise may create difficulty with administration of existing trusts, especially as many trust deeds will approach distribution of income differently to capital distributions, both of which impact the taxable income of beneficiaries and trustees under the new model.

Character flow through and streaming should be retained on a general basis, including the ability to group transactions and stream as a general class, as is available under the current rules. The support of a specific anti-avoidance rule could be considered, but the meaning of the term “distribution” should negate the impact of avoidance opportunities.

To reduce complexity, a prescriptive approach to allocation of expenses between classes should be avoided.

We highlight that our approach to distributing retained income and gains means that streaming will only have a potential impact on the tax position in the year that the income and gains are derived rather than in later years.

Trust loss provisions

The current approach to preserving and accessing trust losses is exceedingly complex and confusing and the legislative approach taken goes much further than policy requires. At present the loss rules are inherently complex and can result in substantial administrative costs for relatively straight forward trust groups. The provisions are in desperate need of reform.

Consistent with the policy that taxable income should be assessed to those who enjoy the economic benefit of the related income and capital gains, the losses should be available to those who bore or funded the losses. For a trust, determining the latter can be difficult due to the potentially wide range of beneficiaries. A policy that allows a deduction against future assessable income of the trust is considered sound.

There should be no need to quarantine tax losses against different types of income even if streaming of classes of income occurs or has occurred within the trust. This is because, for most trusts, a distribution of income cannot occur unless a surplus arises.

The trust loss provisions themselves are in need of industry review and consultation.

Capital gains held by the Trust

Capital gains either retained by the trustee or distributed to individual or trust beneficiaries should be eligible for the 50% CGT discount, irrespective of the period for which the capital gain is retained by the trust.

There is no policy reason why a trust should be disqualified from the benefit of the discount when ultimately it will be the beneficiary's tax status that will determine whether this concession survives.

To do otherwise would treat the trust as a company which is inconsistent with the Government policy noted in the Consultation Paper. Our model is designed so that both income and capital gains will ultimately be distributed to beneficiaries. Removing the discount at the interim trust level would be inconsistent with this approach.

Distribution of offsets generated within the Trust

The trustee will be able to stream offsets when they are distributed to the beneficiaries within the first year of being generated by the Trust.

If offsets are still held after the first year, they should be blended together with tax paid by the trustee. This will enable offsets to be attached to later distributions at an even rate and with limited complexity.

Any other approach would involve considerable complexity and administrative costs for the Trustee.

Trust deed

The recommended model respects the deed of a trust and operates irrespective of the meaning of "income of the trust estate".

With the model requiring more than merely conferring a "present entitlement" for a distribution to arise, many trust deeds will not require alteration. However, some deeds may require alteration to capital distribution clauses. The latter may affect not only capital gains but also retained income.

The definition of "income of the trust estate" does not require modification under this model. The model taxes a beneficiary on the distribution of either income or capital gains.

Notional/deemed amounts and timing differences

The pro-rata approach of taxing a trust's taxable income on the basis of the extent of distribution of trust income and capital gains means that the burden or benefit of any differences between the taxable income and the total of those two amounts will be allocated on a fair basis between the trustee and beneficiaries.

The method of allocating the blended tax credits in subsequent years will minimise the risk of inappropriate taxation to both the revenue and taxpayers as tax differences reverse in later years of income.

Scope of provisions

This model for trust taxation is focused on private trust estates. We have considered the approach to some other types of trusts that are currently assessed via Division 6 and provide the following comments:

- widely held trusts: consideration should be given to exclude them from this model altogether, or at least provide them with an election to be taxed via the Managed Investment Trust provisions

- charitable trusts: as these trusts distribute their income and gains to tax exempt bodies, no tax should apply on retained income and capital gains subject to safeguards such as minimum distribution requirements

- deceased estates & testamentary trusts: while the above model should operate successfully for such trusts, we encourage further consultation to ensure that the specific issues affecting such entities are accommodated

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Worked Example

Assume that the income of a trust for a year of income is as follows:

Interest Income	120
Fully franked dividends (excl. franking credits)	70
Rental income	20
Discount capital gain (gross)	200
Trust income and capital gains	**440**
Add franking gross-up	30
Less CGT discount	(100)
Taxable income of trust	**370**

Note:

1 trust income per the trust deed is equal to taxable income, excluding notional amounts

2 trust income to be streamed as follows:

   a 50% of all franked distributions to beneficiary A

   b 50% of all other income to beneficiary B

   c Balance to be used for reinvestment by the trust

In the above example, the distributable income for trust law purposes is calculated as follows:

Taxable income	370
Less notional amounts (franking gross-up)	(30)
Distributable income per trust deed	**340**

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In the above example, the distributions to beneficiaries and amounts retained and taxed in the hands of the trustee are as follows:

	Entitlements to trust income	Trust income and capital gains relating to entitlement	Taxable income
Beneficiary A	35	35	50 (incl 15 franking gross up)
Beneficiary B	135	185 (incl 50 CGT discount allowed)	135
Trustee	170	220 (incl 50 CGT discount allowed)	185 (incl 15 franking gross up)
Total	**340**	**440**	**370**

The trustee will be taxed as follows (trustee tax rate of 30%):

Taxable income (including franking credit gross up)	185
Tax at 30%	55.5
Less: franking credit offset	(15)
Tax payable	40.5

In this case the trustee would be required to record the following information for each year:

Undistributed trust income and capital gains (ie $220 less trustee tax of $40.50)	179.5
Undistributed taxable income	185
- Including undistributed taxable gains	50
Undistributed tax credits	
- Franking credits	15
- Trustee tax	40.5
Total	55.5

The net of Undistributed trust income and capital gains less trustee tax would represent the trust's **retained earnings (ie $179.50). If $100 was distributed in the next year to Beneficiary A, this would give rise to the following:**

- debit to Undistributed trust income and capital gains account of $100
- debit to Undistributed taxable income account of $103 (ie $100/$179.50 x $185) including a debit for discount capital gains (if this extra complexity is desired) of $28 (ie $100/$179.50 x $50)
- debit to Undistributed tax credits account of $31 (ie $100/$179.50 x $55.50)

- assessable income to Beneficiary A of $103 (including $28 of post-discount capital gains if this extra complexity is desired)
- refundable offsets for Beneficiary A of $31

The amount of undistributed income for each year (and the tax credits thereon), as determined within 10 months of year end or lodgement of the return, if earlier, are added to the above accounts so that they will affect distributions occurring after that time.

The trustee will be able to choose whether a distribution during a year relates to the current year or a prior year. If no choice is made by 10 months after year end or the return lodgement date, if earlier, the distribution will be deemed to occur from the earlier year until all prior amounts are distributed.

Responses to Questions

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

The Consultation Paper canvasses the following policy issues:

Policy Issues

- interaction between distributable income and taxable income
- allocation of taxable income to beneficiaries
- retention of character
- scope and relationship of Division 6 to other divisions
- definition of fixed trusts
- trust loss rules
- family trusts rules

Excluded from the Policy Issues is the "Role of the Trustee" and issues of control of a trust. Significant emphasis is placed on the beneficiary for various tracing tests (trust losses, franking credits, COT tests) which add significant compliance cost and in a number of cases the impracticality in being able to identify the ultimate beneficiary. This description may be better described as the relationship between the Trustee and the Beneficiaries, as a trust is often described as a relationship. The Policy issue should address which rules should be addressed to which party, the Trustee or the Beneficiary.

Whilst the policy issues referred to above cover the critical points to be addressed by the review, the narrowing of the scope such that the beneficiary bears the tax liability reduces the scope for consideration: for example the taxation of the Trust's assessable income to the Trustee and a credit to the beneficiary upon distribution with CGT flow through. Likewise the concept of the fiscal neutrality implies a lack of willingness to deal with the requirements for working capital of trusts. At present all income generally speaking is designed to be eventually taxed to individuals (now at the higher marginal tax rates) as a result of the Division 7A ATO ruling on unpaid present entitlements and the amended integrity rules effective from 1 July 2009. This puts an onerous restriction on Trusts holding working capital compared to a corporate structure. It is acknowledged that Trusts are eligible to, and do carry on significant small to medium sized family business. The growth of these enterprises is restricted by the capital of the trust and need to effectively suffer the maximum rate of personal tax. In a large percentage of cases the use of corporate beneficiaries has enabled

Trusts to have a pseudo access to working capital on an equivalent basis to that of a corporate structure. The changes to Division 7A have significantly reduced this option. The rules under Division 7A could be significantly reduced by applying an "otherwise deductible rule" such that if the unpaid distribution was notionally treated as a loan would the interest be deductible. Integrity measures could be built around this concept. Further the concept of accumulating income in a trust could be explored whereby the trust may retain working funds in the form of accumulated income provided it meets either a use test or otherwise deductible rule if the money is lent to another entity. The question then becomes the rate of Tax applied to accumulated income.

The objectives of the review can be summarised as:

Objectives
- reduce compliance cost
- reduce uncertainty
- primarily assess income to beneficiaries
- reduce complexity
- attach tax liability to economic benefit – "follow the money"
- conceptually robust
- no manipulation of liabilities
- retention of character and source
- trust losses remain with trust
- revenue neutral

Subject to the forgoing comments in respect primarily assessing income to a beneficiary and revenue neutrality the first four dot points are essential parts of this review.

As indicated the Trust vehicles have become a significant structural vehicle used in commerce for their ability to provide:

- multi-generational planning
- limited liability (in conjunction with a corporate trustee)
- control and direction
- flexibility

Until recent years the law surrounding trusts has been relatively stable, albeit complex by nature.

It has only been the recent tax cases exploring tax related issues around income definitions and the interpretation of these under Division 6, Schedule 2F, and the concept of unpaid present entitlements that have increased the degree of uncertainty, resultant complexity of application and therefore compliance cost (in preparation of trust financial statements, tax returns, and in due course the tax administration costs).

As indicated in Section 2.1 the types of trusts and activities conducted through trusts have grown significantly. The users of Trusts, together with many of their advisers, whilst understanding the broad principles of a trust, do not necessarily possess the in depth legal knowledge of equitable principles and taxation law to understand the consequences of the recent developments around *Bamford's* case and the legislative response thereto. Nor do they understand the rules of equity in respect of unpaid present entitlements as they relate to a corporate beneficiary. This is a debate yet to be decided within the Courts.

The stage has been reached where it is not reasonable to expect people with sound commercial experience to be able to operate a trust in Australia without possessing or engaging expert taxation knowledge.

It is critical that simplification of the tax laws related to trusts be undertaken even at the expense of some revenue leakage where that revenue leakage is at the extremities and not the main core compliance areas.

Q.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?

Each issue identified by the Government in sections 2 to 5 of the consultation paper is in need of greater certainty and simplification.

There are a number of additional issues not mentioned in the consultation paper including:

- the 45 Day Rule [Section 207.145 (1) and the former part III AA of the Income Tax Assessment Act 1936]
- the COT Test for Company losses where shares are held by a Trust

These issues should be included to provide greater simplification and ease of management of the issue.

Although it is tempting to break the issues down and deal with them individually, a number can be dealt with by the approach to the rewrite. The Consultation Paper provides three options under Section 8 to be considered and under 6.4 three elements that must be addressed.

In addressing these elements each of the issues raised should be earmarked for consideration either by the architecture of the legislation for example, which Trusts are taxed under the general rules. The remainder should be addressed by specific rules relating to the issues.

Most of these issues can be addressed as part of the review. If however more specific legislation is being developed (for example MIT legislation) then a transitional position or an "as is approach" should apply with an announced time frame for completion.

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Q.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?

As indicated in Question 2 there is a strong preference to deal with as many issues as possible within the one rewrite.

Trusts remain one of the fastest growing structures used in commerce in Australia. Their cost effectiveness and flexibility within family groups and across generations will continue to fuel their use. Such use is not driven primarily by income tax planning but by a desire to provide flexibility for the future while dealing with antiquated State revenues such as Stamp Duty.

There is a need within the community to provide simplicity and ease of understanding as to the tax consequences of using such structures. Addressing only some of the issues will continue to fuel uncertainty at considerable cost to the community.

Q.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?

An exclusion approach should be adopted whereby certain classes of trusts are specifically excluded from the Scope of Division 6. This should be coupled with specific taxation regimes for those classes of excluded trusts. It is preferable that trustees be able to choose to be excluded from Division 6 and taxed under these specific regimes.

A comprehensive list of excluded trusts and related taxation regimes should be developed.

Q.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?

A number of classes of trust may potentially be carved out of Division 6 on the assumption that alternative and simplified regimes are put in place to cover the taxation of these trusts including:

- bare trusts
- fixed trusts
- consolidated trust groups
- deceased estates and testamentary trusts
- widely held trusts
- charitable trusts

Q.6 Is there sufficient uncertainty with the current treatment of expenses to warrant a legislative solution?

At present a number of trust deeds remain silent on the ability and the treatment of how the trust should allocate expenses against income. Going forward, Trust's should remain able to allocate expenses between different classes of income when streaming. Any prescriptive approach invariably involves increasing complexity. This should be avoided.

Q.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 believe a number of adjustments will be required to be made to existing tax concepts including:

- the treatment of notional amounts which aren't physically distributable
- the treatment of discount capital gains
- accommodating the effect of applying prior year revenue and capital losses, especially those incurred prior to commencement of the new model
- accommodating the effect of the trustee having to retain cash in order to pay tax
- how trusts with interest in other trusts will be treated, and what the practical effects of this will be

Q.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?

Our preference is for character flow-through and streaming to be provided on a general basis, with specific limitations in limited situations, eg anti-avoidance. We believe implementing specific provisions will not result in the best treatment as greater specificity can lead to anomalous outcomes.

We believe there should be the broad ability to stream with as many various classes as allowed under the trust deed, including all various types of income that are subject to different taxation treatments, as well as sub-classes within these classes. Trustees should also receive full flexibility and the tax treatment of beneficiaries should be the same as if the income was earned was earned in the hands of the beneficiary.

There should also be the ability to 'group' transactions – eg the current streaming provisions do not allow capital gains as a general class to be distributed, rather specific capital gains must be identified and streamed.

Q.9 How should losses be dealt with where character flow-through of different classes of income is recognised?

In determining the correct treatment of losses we believe the following must be considered:

- flexibility should be a feature of the treatment of losses
- avoidance of implementing an overly complicated system (such as the previous approach to foreign losses)
- the ability for trustee to 'carry back' tax losses, where the trustee has been assessed to tax previously

Q.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?

The areas of tax law identified in Chapter 4 of Consultation paper that may need to be updated or rewritten to ensure that they interact appropriately with an updated and rewritten Division 6 appear to be quite comprehensive, namely:

i Division 6 of the CGT Provisions

ii Division 6 and the Franked Distribution Rules

iii Division 6 and the Consolidation Provisions

iv Division 6 and the Withholding Tax Provisions

v Division 6 and the Non-Commercial Loan Provisions (Division 7A)

vi Division 6 and the New Managed Investment Trust Regime

vii Division 6 and the TFN Withholding Rules

viii Division 6 and the Trustee Beneficiary Reporting Rules

We don't believe that there are any other key areas of the tax law outside of Division 6 that will need to be rewritten or updated after any changes are made to Division 6.

Chapter 4.1 discusses the interaction between Division 6 and the Capital Gains Tax ("CGT") provisions. In our experience, the interaction between Division 6 and the CGT provisions has been a complex and challenging area of the tax law to apply to many client's circumstances. It was anticipated that the recent streaming changes introduced in 2011 was to provide a more efficient mechanism for dealing with capital gains in trusts and distributions and creation of entitlements in the respective beneficiaries.

However, we note that on our initial consideration and application of these streaming provisions, issues around creating specific entitlements to capital gains and making beneficiaries entitled to the entire financial benefit of such capital gains has been challenging. In this regard, if these provisions are to remain intact, we would appreciate further guidance and consideration, whether it be from Treasury or the ATO as to practical application of these new provisions.

The discussion at Chapter 4.1 of the Consultation Paper with respect to CGT appears to consider the common situation where a trust derives a capital gain and seeks to distribute this to its beneficiaries. A further complication with respect to the interaction of Division 6 and the CGT provisions are the Small Business CGT concessions contained within Division 152 of the ITAA 1997. Typically, the small business CGT concessions require the trust to have a significant individual. In determining whether the trust has a significant individual, regard may be had to Section 152-65 of the ITAA 1997.

Broadly, in determining the small business participation percentage as required under Section 152-65, regard is had to distributions of income and capital to the respective beneficiaries. Where there are differences between the income and capital distributions to a beneficiary, the smaller percentage distribution will apply. On the basis that a new model is likely to be introduced into Division 6 and ultimately the mechanism for distributions to beneficiaries may be impacted, regard must be had specifically to the interaction with the small business CGT provisions to ensure that determining eligibility for the small business CGT provisions is clear and simple to apply in practice. Further, taxpayers' ability to access the small business CGT provisions should not be made more onerous as a consequence of the changes to Division 6.

Q.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?

In addition to the comments noted above with respect to the small business CGT concessions, we are of the belief that significant consideration must be given to the interaction between Division 6 and the non-commercial loan provisions (Division 7A). In our experience, Division 7A is one of the most difficult compliance areas for private family taxpayers.

We welcome the comments in Chapter 4.5 of the Consultation Paper that the Government is continuing to monitor the application of Division 7A and, if appropriate, will review the operation of the Division through a separate process. Notwithstanding those comments, we thought it would be appropriate to raise some of our concerns with respect to the interaction of Division 6 and Division 7A in our submission.

The two key areas within Division 7A that cause significant concern amongst our clients are:

- distributions which are made to corporate beneficiaries and remain unpaid; and

- loans to shareholders (or their associates) of corporate beneficiaries, where the corporate beneficiary has an entitlement to a distribution from the trust

In relation to the first situation, the release of Taxation Ruling TR2010/3 "Division 7A Loan: Trust Entitlements", with respect represented a significant departure by the Commissioner of Taxation from his previous administrative treatment of unpaid entitlements to corporate beneficiaries. Whilst we do not wish to discuss in detail the comments in that Taxation Ruling, we note that the use by family groups of trusts and corporate beneficiaries is an extremely common group structure.

In many cases, the funds represented by the distribution to that corporate beneficiary are retained in that trust (or used by other entities within that family group) for business and investment purposes. These funds are essentially the working capital for the family group. Therefore, the treatment of such unpaid entitlements as a Division 7A loan from the company back to the trust has caused significant concern amongst our client base. In the situation where such funds are retained by the trust as working capital and applied to productive purposes, we fail to see the mischief that has been carried out. In addition to the significant commercial and structuring concerns arising from this Taxation Ruling, it has imposed a further significant compliance requirement at year end. As such, we implore Treasury (and the ATO) to give further consideration to the interaction between Division 6 and Division 7A in relation to the common scenario just described.

In the second situation described, subsequent to the trust having an unpaid entitlement owing to a corporate beneficiary, it may then seek to lend the funds representing that entitlement to other persons or entities within the family group. Under Division 7A, this would typically result in that corporate beneficiary being deemed to have made a loan to that person(s). As such, a principal and interest loan agreement will typically be required to be put in place.

Division 7A does not consider the purpose of the loan funds provided by the trust. Commonly, such loan funds are used by the other entities for income producing purposes. As indicated above, this deeming of a loan from the corporate beneficiary to the persons or entities within the family group creates significant commercial and compliance concerns. In this regard, we strongly believe that consideration could be given to introducing a rule similar to the otherwise deductible rule found within the Fringe Benefits Tax provisions. Having such a rule in place would alleviate a significant compliance requirement for these trusts and allow family groups to continue to structure their activities as they have done so for many years.

In summary, significant consideration must be given to the operation of Division 7A and its interaction with Division 6 in respect of the typical family group that we are advisors to. We acknowledge the role that Division 7A played as an anti-avoidance provision, however we strongly believe that other alternatives are available to tackle any perceived abuse by family trusts and closely held group structures.

Q.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?

There should be five broad categories of Trust tax regimes in addition to the Managed Investment Trust provisions. These would be:

- **Simplified Trust Taxation –** subject to certain thresholds trustees should be able to choose to join the regime
- **Fixed Trust –** subject to certain parameters fixed trusts and non-fixed trusts should be able choose to be taxed as fixed trusts
- **Consolidated Trust Groups –** subject to certain parameters Trusts controlled by the same family group should be able to consolidate in some form for income tax purposes
- **Division 6 –** other trusts would be taxed under the revised provisions of Division 6
- **Deceased Estates and Testamentary Trusts –** this regime would provide greater certainty as to the application of the taxation of income and capital

Our comments envisage alternative models of simplified taxation for small trusts and fixed trusts. These regimes would provide certainty and a reduced compliance burden including the removal of the need for a Trustee to lodge a return. In return the parameters in which they operated would be limited and there could be consequences for moving outside these parameters. The parameters may include limiting or effectively fixing the entitlements of beneficiaries within the confines of a family group.

Where more complex arrangements exist, Trusts should be able to elect to form Consolidated Groups and be taxed as single entities where they are controlled by the same family group.

Q.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?

A "Proportionate within class model" will require a definition of distributable income on the assumption that distributable income will no longer be determined by the Trust Deed. Each class of income will require guidance on the definition or calculation of distributable income for that class. We imagine that there will need to be a general class of income which would be defined so that the distinction between income and capital is clear. When calculating the distributable income of each class a definition of distributable income is required to provide clarity about the allocation of expenses between classes.

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Q.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?

As discussed earlier in our submission, under a TAD model, there should be a reduction in the rate of tax applied to trustees on accumulated income to 30%.

This would effectively remove the issues around UPEs with corporate beneficiaries.

- the accumulated income would be an accretion to capital and records would need to be maintained by the trustee to support the amounts of future distributions and the related tax credits. These distributions would then be taxed as income in the hands of beneficiaries, with a credit provided for tax paid by the trustee and other related tax offsets

- certain integrity measures would need to be introduced to prevent trusts being used to meet certain non-deductible expenses on-behalf of beneficiaries

Q.15 If a TAD model was adopted, how should the tax law define the concept of a 'distribution'?

As discussed in our submission above, distribution should be defined as an actual payment of cash or application of funds on behalf of the beneficiary. Therefore, distribution would not include credits to UPE's or beneficiary's loan accounts.

This definition would meet the policy objective of 'following the money'.

Q.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?

It may be appropriate to consider an extension of rollover provisions and the section 152 concessions to assist the transition from discretionary trusts to companies in situations where trusts are no longer the most appropriate vehicle.

In addition, distribution of retained trust funds (whether capital or income) should not be affected by the new regime. Also, UPEs and section 2 loans up to the date of application of the changes should be ring-fenced with continuation of Division 7A or sub-trust arrangements until the amounts are cleared.

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General comments

- legislation should provide that for tax purposes trust distributions should only influence the tax outcome where an economic benefit passes to beneficiaries rather than relying on the equitable notion of present entitlement. Among other things, this would negate issues that currently arise around determining when present entitlement arises

- should business income have a different treatment from passive sources of income? For example, a disparate approach may be considered so that no penalty applies if income is retained for working capital purposes. If so, the scope of such a concession would need to be considered including, if only applicable to businesses as such, what definition of business would apply – eg the ordinary meaning or a narrower legislated definition?

- Section 99B is drafted so that it applies in a very broad sense, including in situations that are not intended. This provision should not apply in a domestic setting. Further, whether and how it should apply for cross-border trust distributions needs re-assessment as part of the review of the taxation of foreign income. In this regard, if the foreign income accrual regime is operating effectively, there should be limited need for section 99B. Further, a provision like this should not operate in an adverse way for people relocating to Australia. Currently, expatriates commencing residency can be unfairly taxed while prevailing structures are unwound

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