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Dear Ms Barron

Modernising the Taxation of Trust Income - Options for Reform. Discussion Paper (November 2011)

This submission responds to the issues raised in the Treasury Discussion Paper, *Modernising the Taxation of Trust Income – Options for Reform* (November 2011) (**the Paper**).

The submission is in 3 parts. The first part is argues for a clearer and simpler exposition in the Paper of the problems that need to be solved so that the overall goal of the project is more evident; the second comments on the Paper's general approach to the task of reforming the taxation of income derived through a trust; and the third part addresses specifically the Consultation Questions set out in the Paper [pp. 43-44].

1 Isolating the underlying concern more precisely

Before addressing the express content of the Paper, we consider that it will help the consultation process to isolate and articulate simply and clearly the underlying motivation for this project.

It seems to us that this project is driven by an unstated agenda – that the current method of allocating the tax liability on trust income between beneficiaries is insufficiently robust: the current rules are too open to manipulation and abuse. That perception of a lack of integrity may be thought to appear at several points in Division 6: the reliance on trust law, the significance that this reliance attaches to the Deed, the relevance for tax law of powers conferred on trustees, and so on. At the moment, it seems to us, the Paper is focussed on manifestations of that single underlying concern, without actually articulating it.

If, as we believe, the motivation for this project is a concern about the integrity of the current method for allocating the tax liability on trust income, it seems to us that 2 propositions then follow.

First, the problems which need to be addressed arise principally in the private closely-held trust context. Commercial vehicles such as collective investment funds and special purpose trusts which do not happen to satisfy the managed investment trust (**MIT**) definition – and there will be many, particularly at the wholesale level – are not typically prone to the kinds of abuse seen in the closely-held context, and yet they will be subject to these rules for no good reason.

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Second, problems of abuse and avoidance should be addressed – and are already addressed – directly through measures which target situations of abuse and avoidance. It seems to us both unnecessary and undesirable to change the rules for all (non-MIT) trusts as a means of controlling the behaviour of a few aggressive taxpayers.

2 General observations on the Paper

2.1 The perception of uncertainty [Questions 2, 4]

We wish to record at the outset our general disagreement with the impression conveyed by the Paper that the law on the taxation of income derived through trusts is in a state of disarray. There are some areas where the law does not achieve desirable outcomes, but they are not evidence of confusion or uncertainty in the law.

The ATO has claimed for some time that such a state of affairs exists. In a discussion paper prepared by the ATO in 2009, the ATO said:

> *"The Tax Office does not consider that any of the meaning of 'income of the trust estate' in subsection 97(1), the meaning of 'share' in that provision, the relevance of, and measurement of, distributable net income of the trust in determining present entitlement of beneficiaries is settled law."*

While the ATO may have held such a view, it is hard to see the basis for it, either at that time or today. Indeed, the High Court's judgment in *FCT v. Bamford [2010]HCA10* was short, clear and entirely conventional. It rejected the ATO's argument about the meaning of 'income of the trust estate' in just 7 paragraphs: [36] – [42] and dispensed with the taxpayer's argument about 'share' in just 4 paragraphs: [43] – [46]. The judgment of the Full Federal Court was similarly straightforward. Both judgments affirmed the profession's understanding of how the rules work, an understanding that was regarded as conventional and uncontroversial until a few years ago.

What the *Bamford* saga shows is that the ATO has been keen to test some arguments before the Courts and that those arguments have failed. Further, where intermediate Courts have ruled on particular issues, the ATO has often viewed those decisions as not determinative. But the failure of the ATO's ventures says nothing about the state of the law; all that it reveals is the attitude of the administration.

Hence, we disagree with the repeated statements in the Paper that the current law is fundamentally unsatisfactory. The Paper claims, at various places, that the current rules are 'complex,' 'uncertain' and 'lacking clarity' and cites as the evidence of this 'continued litigation decades after [the] introduction' of Division 6. The recent litigation is evidence of nothing more than the ATO's desire to test a number of propositions which, it turned out, were incorrect. And so, when the Paper says:

> *"The Government is updating and rewriting the trust income tax provisions to increase certainty ...* [p. 2]"

in our view, there is a simpler route to this goal – to return to the conception of the trust provisions as they are understood by the profession, and were administered prior to the ATO's change of practice.

The same observation can be made about other areas of trust law and ATO practice. For example, the ATO's Technical Discussion Paper – TPD 2011/1 – Securitisation and TOFA, concluded that:

> *"The matter is not free from doubt, but the better view is that Division 6 can apply to such a constructive trust arising from an equitable assignment."*

Again, this position is directly at odds with the practice that has been adopted for many years that equitable assignments and securitisation vehicles do not create an additional entity subject to Division 6.

We acknowledge there are problems in the law – but the most significant issues which require legislative remedies arise in the areas listed at 2.6 of our submission (see below), not in the main allocation mechanism in Division 6.

2.2 Underlying principles [Question 1]

The Paper sets out 5 principles for the design of the trust regime. It is hard to disagree with them given their level of generality, but 2 comments should be made:

- the first principle:

  1. Tax liabilities in respect of the income and gains of a trust should 'follow the money' in that they should attach to the entities that receive the economic benefits from the trust ...

  should not be interpreted in such a way that it requires trusts to distribute money in order to avoid tax being imposed on the trustee. In this respect, the use of the word '*receive*' is not helpful. The principle would be better expressed as:

  1. Tax liabilities should attach to the entities that are, or will become, entitled to the economic benefits from the trust.

- the fourth principle is not well expressed. If these 5 'principles' are presented to set out a guide to the future design of a trust regime, this principle should read as an affirmative statement of intent:

  4. Amounts obtained by trustees will retain their character and source when they flow-through, or are assessed, to beneficiaries.

But if this principle as presented in the Paper is meant to capture the current state of the law, we cannot agree with it. This is discussed further at section 2.4 of our submission (see below).

2.3 Scope of trust regime [Question 5]

As was noted above, it seems that the ATO has decided to revisit the scope of the trust regime in Division 6, and in particular whether bare trusts, constructive trusts and similar arrangements are subject to the operation of Division 6. Given that this has occurred, it is probably desirable that the scope of Division 6 be clarified in legislation.

If this is to be done for Division 6, it is also desirable that the notion of 'absolute entitlement' in the CGT rules be clarified at the same time. In our submission, the 2 concepts should be aligned.

In other words, it should be made clear that the Division 6 regime will be invoked (with the effect that losses are trapped within the trust) and the CGT rules are invoked (so that capital gains and losses are calculated in determining the net income of the trust estate) only where either:

- the trustee has been invested by the trust's constituent documents with management powers to make and vary the investment of the trust assets, or
- the trustee has been given the power to appoint income between beneficiaries.

In the absence of either of these powers, the trust relationship should be treated as transparent for tax purposes.

This would remove from the scope of any new trust regime a wide variety of arrangements where the trust is simply an arrangement for the convenient holding of ownership of specified assets for designated beneficiaries in fixed proportions.

It should ensure that neither the Division 6 rules nor the CGT rules would be attracted to constructive trusts, equitable assignments, bare trusts, custodian arrangements, nominees, IDPS (investor directed portfolio service), IMAs (investor managed accounts) and SMAs (separately managed account). For all of these arrangements, a simple attribution of income / deduction / realised gain / realised loss is both feasible and conceptually appropriate. It also conforms to long-standing administrative practice for bare trusts.

Another way of achieving this outcome would be to allow trusts with these features to make an election to be taxed as partnerships.

2.4 Source and character [Questions 8, 9]

We made the point above that the fourth principle – set out at p.3 of the paper – implies a level of uncertainty about the character and source of amounts taxed to beneficiaries which does not exist. In our view, it is clear that:

> "*amounts obtained by trustees retain their character and source when they flow-through, or are assessed, to beneficiaries* [p. 3]"

It is not entirely clear what is the exact nature of the uncertainty being alluded to. The Paper may be implying doubt about 2 different things:

- a notion that amounts which emerge from a trust have taken on a new character – that what the trustee received as dividend or rent emerges from the trust as an amount with a new character, a 'trust distribution'; or
- a notion that beneficiaries must axiomatically take a share of all types of income, regardless of the provisions of the Deed – that all beneficiaries enjoy a proportion of both dividends and rent, where the trustee received dividends and rent, notwithstanding that the trustee holds the dividends for beneficiary X and the rent for beneficiary Y.

In our submission, both propositions are wrong. A trust is a relationship between various people about the handling of property. Nothing in the nature of that relationship is capable of changing the source or character of the amounts which are subject to it.

This means that the amounts derived by the trustee (which it collected as interest, rent, gains etc) are and remain the same kind of amount if the trustee distributes or appoints those amounts to beneficiaries. The trustee may have a power to appoint more of one kind of income to some beneficiaries than others, but this does not change the basic position.

The accepted treatment for the last 60 years (ie, since *Charles v FCT* [1954] HCA 16) is that amounts to be taxed to the beneficiary have the same source and character as when they were derived by the trustee. The High Court was quite clear:

> *"the question whether moneys distributed to unit holders under the trust form part of their income or of their capital must be answered by considering the character of those moneys in the hands of the trustees before the distribution is made."*

There is nothing in the judgment in *Bamford* that requires a different view. There is nothing in the text of the High Court's judgment which provides explicit (or even implicit) support for the ATO's view, expressed in its Decision Impact Statement, that:

> *"the amount included in a beneficiary's assessable income under section 97 consists of an un-dissected or un-allocated proportionate share of the entirety of the [tax] net income."*

Furthermore, a power in a trust deed which allows a trustee to re-characterise various kinds of income (or to treat as income / capital amounts which the trustee received as capital / income) should be understood to be simply a power that has effects for the purposes of ascertaining and quantifying the entitlements of beneficiaries *inter se*. Such a power cannot – and does not – change for tax law purposes the character of the amounts which the trustee has derived or which it is distributing / applying.

2.5 The attribution models [Questions 12-15]

The 3 models. The core of the Paper proposes 3 possible models for reforming the taxation of income flowing through trusts. None of them are compelling; indeed none of them represents a significant improvement on the core design features of the current system, and all appear quite capable of producing anomalous results.

The Patch Model proposes enacting a definition of the term 'income of the trust estate.' This would remove from settlors or trustees the ability to influence many aspects of the trust's tax position that are currently controllable, either through the drafting of the Deed or by the exercise of powers conferred on trustees.

Where this definition would come from is not obvious and the Paper canvasses using some existing definition in the tax legislation, using accounting concepts or enacting a few mandatory additions. This part of the Paper draws heavily on the options set out in the Treasury discussion paper, *Improving the Taxation of Trust Income*, released on 4 March 2011. These options were the subject of much criticism at the time and those criticisms remain valid.

The Proportionate Allocation Within Class Model involves assessing beneficiaries on their proportionate share of each class of income earned by the trust. The income classes could be determined with reference to the trust's deed or they might be set out for tax purposes in the tax legislation. Why this process would solve the problems itemised earlier in the Paper is not obvious. Presumably there would still be a need to determine the 'income of the trust estate', albeit by class, and this method would therefore also need to incorporate some aspects of the Patch model.

The Distribution Deduction Regime would assess beneficiaries only on amounts physically distributed to them (or applied for their benefit) and assess the trustee on the remainder of a trust's taxable income. This seems to be Treasury's preferred model and its benefits are elaborated at some length. This model was discussed early in the review of the taxation of MITs but was discarded in favour of the attribution regime now being designed. The discussion of this model says simply that many of the problems identified earlier in the Paper could be accommodated in such a regime: streaming would remain feasible; it could be prescribed that income retains its character when distributed and so on. Such a regime would seriously impinge on the distribution policies of trusts.

The linking of the tax position of the trustee and beneficiaries to amounts being physically distributed may result in trustees being required to make fundamental changes to existing practices about when, whether and how distributions are made. It is quite common for capital gains to be retained within trusts for reinvestment – that is, for the assessable income generated by the realisation of a capital asset to be attributed to the beneficiaries without a corresponding immediate cash flow. This is particularly relevant for those trusts that have been established for collective investment purposes, but do not ultimately fall into the MIT regime. It is always unhelpful when tax law distorts commercial decision-making.

The Paper contains no adequate discussion about the most important issues associated with a distribution-based model – how to 'distribute' amounts which are mere fictions of the tax system that increase (or decrease) taxable income. The tax system contains many fictitious (or accelerated) inclusions in assessable income – franking credits, foreign income taxes paid, TOFA amounts and CFC (and, in the future, FAF) attributions, for example. It also has many allowable deductions that do not diminish cash – Division 40 or Division 43, for example. The result is that the relationship between the amount of funds available for distribution and the taxable income of a trust is tenuous. In short, whether a trust can fully eliminate the entity level tax would thus seem to depend upon the rather fortuitous balance between its tax-generated additional deductions and its tax-generated additional income inclusions (or its willingness to take on debt or return capital to fund adequate levels of cash distribution).

Moreover, this model will require much tinkering to ensure the continued ability of trusts to distribute tax preferred amounts without triggering further tax at the investor level. The ability of trusts to pass through such amounts needs to be maintained so as to ensure the alignment between direct investment and investment via a trust.

Only the first of these models addresses the ATO's concern with the current law that the term 'income' is malleable and can be adjusted by the terms of the trust deed or the exercise of a power held by the trustee.

A better approach. More generally, none of these models is a marked improvement on the current design of Division 6. Those rules:

- allocate the entire tax liability to tax on the taxable income of a trust – either to beneficiaries, the trustee or to each in part;
- allocate the tax liability regardless of cash flows to beneficiaries – so that the tax system does not interfere with the distribution policies of trusts;
- allocate the liability using an observable criterion – the share of the trust's income which each beneficiary is entitled to demand;
- allocate the liability using a criterion that is commercially sensible and reflects (albeit, not the entire) economic gain.

In our submission, an approach that is based on these familiar design features is likely to prove the most workable and least disruptive.

We can, however, see merit in making 4 adjustments to the current design:

- it may be that the criterion to be used for allocating the tax liability between beneficiaries could be made broader than sharing in just 'the income of' the trust estate. We can see some merit in using instead the share of some larger realised amount. But it is important to note that changing to a more expansive criterion would make no difference to most commercial trusts where beneficiaries have uniform rights to enjoy income and capital. It may be necessary for privately-held trusts where entitlements differ or can be made to differ. Having said that, we consider that the compromise reached in *Taxation Laws Amendment (2011 Measures No 5) Act 2011* – using a share of just the 'income' of the trust, buttressed by an anti-avoidance rule where using that indicator gives a result which is inappropriate – is a plausible position;
- the criterion used to allocate the tax liability between beneficiaries (be it share of 'income' or share of 'the realised income and gains' or share of something else) should be legislated, and not something that can be prescribed by the Trust Deed or can be affected by the exercise of trustee powers;
- whatever indicator is chosen for allocating the tax liability between beneficiaries, the system should not also require cash distributions of amounts in order for amounts to be assessed to beneficiaries. There are many trusts which, for sensible commercial reasons, do not distribute (and the Deeds limit the distribution of) amounts representing capital gains. Moreover, there is the problem noted above of physically distributing cash or property representing tax fictions be they timing (TOFA amounts or accelerated depreciation) or permanent (FITOs and franking credits). How much cash is to be distributed to beneficiaries and at what times should be the subject of the rules in the Deed; and
- it follows from the last point that the current test of 'present entitlement' – which can only be satisfied where a beneficiary has a present right to demand immediate payment – is not appropriate if a broader indicator than share of the 'income' of the trust is to be used. At present, trust deeds (or trustee resolutions) will make beneficiaries presently entitled to a share of the 'income' – and only the 'income' – of the trust. That is all the trustee can be required to disburse in cash. If a more comprehensive criterion for allocating the tax liability between beneficiaries is to be used, the 'present entitlement' test will need to be replaced by a broader notion – something such as 'entitled to enjoy in the current or in future years.'

2.6 The real problem areas requiring legislative reform [Questions 2, 10]

The Paper chooses to focus most attention on areas of trust law that are not especially defective. This, of course, leads to insufficient attention being paid to the areas of trust tax law that are deeply flawed:

- the definitions of 'fixed trust' and 'fixed entitlement' in ITAA 1936 Sch 2F, Div 272. (This is a separate problem to the trust loss rules listed next, because the definition affects the operation of other provisions such as the CGT discount rules [Div 115], the 45-day rule, the tracing rules for corporate losses [Div 165], the scrip-for-scrip rules [s. 124-781], the closely-held trust rules [Div 6D] and so on); and
- the trust loss rules in ITAA 1936 Sch 2F.

To some extent, the problems in these 2 areas arise from ATO administrative practices – in other words, it would be possible for the ATO to solve some of the problems that arise in practice through adopting more sensible interpretations of the terms. But in the absence of any indication that the ATO will change its practice, legislative rectification is required.

In our submission, these are the critical areas for reform. Hence, the emphasis on the agenda set out in the Paper is misplaced. In particular, the suggestion on p. 3 of 'a separate process' in the future to rectify the definitions of 'fixed trust' should instead be incorporated into the current process and be made an immediate priority.

3 Specific responses

Many of the comments above address the specific questions posed in the Paper and so they are not repeated here in full.

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

No – see 2.2 above. As statements of aspiration they are acceptable with some modifications, but as statements of the existing legal framework, they do not correctly reflect the existing framework for the taxation of trusts.

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?

No – see 2.6 above. The topics identified on page 3 of the Paper as priority areas are important but not critical. The definitions of fixed trust and fixed entitlement, and the trust loss rules in general should be included in the current process.

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?

We have no view on this matter.

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?

See 2.3 above.

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?

See 2.3 above.

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

No. Trust law should continue to permit expenses to be allocated against income classes based on 'a reasonable allocation.'

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?

The question is misconceived – the term 'distributable income' does not need to be defined for tax purposes. It certainly should not be defined using tax concepts. The term should remain what it is – the amount which the trust deed permits / requires to be distributed or applied for the benefit of the beneficiaries of the trust. The term should remain a term that has importance only for trust purposes.

The real question is, what is (or should be) the basis for allocating the tax liability on the taxable income of a trust among the various parties – see 2.5 above? This question might be answered by reference to the enjoyment of the 'income' of the trust (with the word 'income' understood to mean the net amounts available for distribution) or by using some more comprehensive criterion. But the critical question is not how to make the notion of distributable income workable, but rather, what is (or should be) the basis for allocating the tax liability on the taxable income of a trust among the various parties.

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?

See 2.4 above.

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

See 2.4 above.

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?

See 2.6 above.

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?

See 2.5 above.

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?

See 2.5 above.

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?

See 2.5 above.

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?

See 2.5 above.

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

See 2.5 above.

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?

We have no view on this matter except to note that the small business sector – which is one area of the economy that will be significantly affected by any change – is unlikely to be able to respond quickly to significant systemic changes. Some form of grandfathering may also be required for trusts that are not MITs but have been marketed on the basis of existing tax law and treatment.

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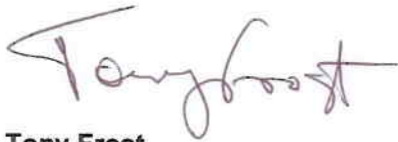
We trust that these comments are useful to your deliberations. If you have questions about any of the issues we have raised in this submissions, please feel free to contact Andrew Mills (02) 9225 5966 for clarification.

Yours sincerely



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