Hayes Knight
Accountants & Business Advisers

Hayes Knight (NSW) Pty Ltd
ABN: 73 114 354 246
Level 2, 115 Pitt Street, Sydney NSW 2000
GPO Box 4565 Sydney NSW 2001
T: 02 9221 6666 F: 02 9221 6305
www.hayesknight.com.au

10 February 2012

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

Dear Sir

RE: Consultation paper – Modernising the taxation of trust income

Thank you for the opportunity to provide comments on the consultation paper released in November 2011 relating to the taxation of trust income.

The Hayes Knight group of accounting firms provide a significant amount of taxation advice to small and medium business taxpayers throughout Australia and we also provide advice to a large number of other accounting firms through the support service we operate. The tax treatment of trust income is a significant consideration for this market segment.

Without seeking to comment on all the issues raised in the consultation paper, we would like to address a number of specific issues relating to the taxation of trust income.

Unless otherwise stated, references are to the *Income Tax Assessment Act 1997* ('ITAA 1997') or the *Income Tax Assessment Act 1936* ('ITAA 1936').

1) Franking credits and qualified person rules

Section 207-150 ITAA 1997 operates to prevent beneficiaries of a trust from claiming a tax offset for franking credits received indirectly through a trust if the beneficiary is not a qualified person in relation to the distribution for the purposes of Division 1A of former Part IIIAA of the ITAA 1936.

Due to the introduction of the Simplified Imputation System into the ITAA 1997 the 'qualified person' rules contained in Division 1A of Part IIIAA of the ITAA 1936 ceased to have application from 1 July 2002.

The Australian Taxation Office ('ATO') confirmed in Taxation Determination TD 2007/11 that it is necessary to have regard to the rules in Division 1A of former Part IIIAA in determining whether an entity is a qualified person for the purposes of paragraphs 207-145(1)(a) and 207-150(1)(a) of the ITAA 1997 in respect of a franked distribution made directly or indirectly after 30 June 2002.

The Government confirmed in the 2008 Federal budget that it will finalise the implementation of the Simplified Imputation System into the ITAA 1997 by introducing the qualified person rules (ie, the

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holding period rules and related payment rules) into this Act. As at the date of this submission the Government has not yet implemented these rules.

As part of the reforms to the trust income tax provisions, the Government should consider finalising the introduction of the qualified person rules into the ITAA 1997 to provide certainty and clarity for beneficiaries who receive distributions of franked distributions indirectly through trusts.

2) Timing of family trust elections & interposed entity elections

a) Family trust elections
Trusts which have made family trust elections are subject to concessional tax treatment such as:

- Most of the trust loss measures do not apply to them, or apply in a modified way.
- Under the company loss recoupment rules, where shares in a company are held by a family trust, the trustee of the family trust will be taken to own the interests as an individual.
- For the purposes of the franking credit trading measures, where a trustee is a qualified person and the trust has elected to be a family trust, it is generally easier for beneficiaries to access the franking credits on franked dividends distributed to them.
- These trusts are not required to make trustee beneficiary statements.

To be treated as a family trust for tax purposes, the trustee must make and lodge a family trust election with the ATO. The election lodged must specify the income year from which the election will be effective.

Section 272-80(4A) of Schedule 2F of the ITAA 1936 allows the trustee of a trust to make a retrospective family trust election if certain conditions are satisfied. This section was inserted by *Tax Laws Amendment (2004 Measures No. 7) Act 2005* with effect from 1 April 2005 and permits retrospective elections to be made from the 2004/2005 income year. It is not possible to specify an income year prior to the 2004/2005 income year. While the ATO has provided some administrative opportunities for trustees to lodge a family trust election from the 1994-1995 year (ie, from when the trust loss rules were introduced) these opportunities have expired.

As part of the current reforms, the Government should consider making amendments to allow trustees to specify an income year from the 1994/1995 year as a matter of practical compliance and sensible administration. As with the current rules, trustees should only be permitted to make a retrospective election from the 1994/1995 year if the trust has always acted like a family trust (ie, family control test is passed, no distributions have been made outside the family group).

b) Interposed entity elections
The Government should consider making similar amendments to allow interposed entity elections to be made retrospectively from the 1994/1995 year.

c) Retrospective family trust elections and franking credits
The Government should also clarify whether a retrospective family trust election and/or interposed entity election is effective in relation to prior year franked distributions received by beneficiaries of a trust.

For example, if a beneficiary of a discretionary trust received a franked distribution from a trust during the 2010 income year but the trustee had not made a family trust election prior to the lodgement of the trust's tax return, the beneficiary would only have been entitled to claim the

franking credits in their personal tax return in very limited circumstances (eg, if they met the $5,000 small shareholder exemption). If the trustee makes a retrospective family trust election when lodging its 2011 tax return, specifying that the election is to apply from the 2010 income year, it is not clear whether this election will ensure that the beneficiary is entitled to the franking credits in relation to the dividends that were distributed in the 2010 income year.

3) Trust streaming rules

a) Streaming other types of income
As a result of provisions introduced by the Government in *Tax Laws Amendment (2011 Measures No. 5) Act 2011*, capital gains and franked distributions can be 'streamed' to specific beneficiaries for tax purposes if certain conditions are met. However, the operation of these rules appears to prevent the trustee from streaming other classes of income in a tax effective manner.

As part of the reforms to the trust income tax provisions, the Government should consider expanding the ability for a trustee to stream other types of income such as:

- Foreign sourced income
- Unfranked dividends
- Passive investment income
- Business income
- Interest income
- Royalty income

b) Terms of trust deed
The Government should also provide clarity in situations where a trust deed is silent on the ability of the trustee to stream particular classes of income to specific beneficiaries.

The trust streaming legislation and explanatory memorandum indicate that streaming will not be tax effective in situations where the trust deed specifically prohibits the streaming of income. However, it is not entirely clear whether streaming can be effective for tax purposes if the trust deed is silent on the matter.

The ATO's view on this issue prior to the introduction of the new streaming rules was that streaming could still be tax effective if the trust deed was silent as long as the records maintained by the trust were sufficient to identify the different classes of income that had been derived by the trust and distributed to the beneficiaries (refer to Taxation Ruling TR 92/13 which has been withdrawn).

As part of the reforms to the trust income tax provisions, the Government should clarify this specific issue. Our view is that the Government should confirm that streaming can be effective for tax purposes if the deed is silent on this issue, as long as the conditions that were set out in TR 92/13 have been satisfied.

4) Trust ceasing to be a resident of Australia

For the purposes of the capital gains tax ('CGT') rules, a trust (other than a unit trust) is a 'resident trust for CGT purposes' for an income year if, at any time during the income year, a trustee is an Australian resident or the central management and control of the trust is in Australia (refer to section 995-1 of the ITAA 1997).

CGT event I2 is triggered if a trust ceases to be a resident trust for CGT purposes (refer to section 104-170 of the ITAA 1997). The time of the CGT event is when the trust stops being a resident trust. A capital gain will arise under this CGT event if the market value of certain assets owned by the trust at the time it ceases to be an Australian resident exceeds the cost base of those assets.

Based on a strict reading of section 104-170 and section 995-1 it appears that a trust can only cease being classified as a resident trust for CGT purposes on 30 June or the following 1 July. This is because section 995-1 treats a trust as a resident trust for CGT purposes for the entire income year if the trustee is a resident of Australia at any time during that year, even if this occurs only for a single day during the income year.

Taxation Determination TD 1999/83 deals with this issue from an administrative perspective. The ATO takes the sensible approach of treating the CGT event as having been triggered when the residency conditions are no longer met (eg, when the trustee ceases being an Australian resident) rather than at the end of that income year.

A similar issue (albeit in reverse) arises in the situation when a trust becomes a resident trust for CGT purposes (refer to section 855-50 of the ITAA 1997).

For the avoidance of doubt the Government should clarify the operation of these sections through legislative amendment.

5) Section 99B

Subsection 99B(1) of the ITAA 1936 applies where an amount of trust property is paid to, or applied for the benefit of, a beneficiary during an income year and the beneficiary is a resident at any time during that income year (subject to some exceptions). Where these conditions are satisfied, the amount is included in the assessable income of the beneficiary.

In our view section 99B should be triggered at the time the beneficiary becomes entitled to receive an amount from the trust rather than when the amount is actually paid or applied for their benefit. This would ensure that section 99B operates consistently with the general provisions that tax trust income in Division 6.

Also, the legislation should be amended to clarify that this provision cannot apply to foreign income that was derived by the trust while the beneficiary was a non-resident (assuming the trustee has maintained records to demonstrate that this is the case). As above, this would improve the consistency between section 99B and the general provisions in Division 6. Refer to ATO ID 2011/93 for an example of a situation in which the ATO has applied section 99B to the payment of foreign income that was derived while the beneficiary was a non-resident.

6) Application of Division 7A to unpaid present entitlements

We note from the consultation paper that the Government is continuing to monitor the application of Division 7A and may review the operation of these rules through a separate process. Due to significant changes to the ATO’s interpretation of certain aspects of Division 7A our view is that the Government should consider the application of Division 7A to trusts as part of the current review process.

Prior to 16 December 2009, the ATO's stated view was that an unpaid present entitlement owed by a trust to its beneficiaries did not generally fall within the definition of a loan for the purposes of Division 7A unless some action was taken by the relevant parties in order to convert the unpaid amount to a loan arrangement. From 16 December 2009 the ATO has stated that an unpaid present entitlement can be treated as a loan under section 109D ITAA 1936.

This represents a significant departure from previous ATO guidance on this issue and has led to a significant level of confusion and uncertainty for tax practitioners and their clients. As a result, taxpayers have effectively been forced to put in place loan agreements and/or complex sub-trust arrangements (sometimes at considerable cost) in order to meet the ATO's new expectations and prevent the ATO from issuing adverse assessments due to the operation of Division 7A.

In the ATO Compliance Program for 2011/2012 the Commissioner states the following:

"To help provide certainty regarding whether an unpaid present entitlement can satisfy the extended definition of loan for Division 7A purposes, we are working with the tax profession to identify a suitable case for test case funding."

We also note that Division 7A contains specific provisions dealing with the situation where unpaid present entitlements are owed by a trust to a company. Subdivision EA of Division 7A applies to trigger a deemed dividend where an unpaid present entitlement is owed to a private company and the trustee also makes funds available to a shareholder of that company (or their associates).

Given the uncertainty surrounding this issue and the significant number of taxpayers affected by this matter, the Government should deal with this issue as a priority as part of the current review of the taxation of trust income. The Government should clarify through legislative amendment whether unpaid present entitlements fall within the definition of loan for Division 7A purposes as well as clarifying the intended scope and operation of Subdivision EA.

Also, the Government will need to consider the impact that changes to the general model for taxing trust income under Division 6 will have on the operation of Division 7A.

7) CGT Event E4

The Government should consider amending the rules relating to CGT event E4 to allow upward cost base adjustments in the event that a beneficiary of a fixed trust is taxed on an amount that is greater than the distribution that is received.

As the rules currently stand, if a payment is made to a beneficiary of a fixed trust that is not included in their assessable income, CGT event E4 applies to reduce the cost base of the interests held in the trust by the non-assessable portion of the payment (unless an exception applies). However, there is no upward cost base adjustment in the reverse situation.

In many cases, a beneficiary will receive a non-assessable payment from a trust because of a timing issue (ie, different rules for recognising income and expenses) that will often be reversed in a subsequent income year.

We note that the Government has recently indicated that this type of upward cost base adjustment may be available to investors of managed investment trusts. Our view is that this type of adjustment should be made available to all beneficiaries holding fixed interests in trusts.

In addition, it is difficult to see why CGT event E4 should be triggered upon the receipt of a small business 50% active asset reduction amount while it will not be triggered upon the receipt of a 50% CGT discount amount. In our view, the distribution of the exempt portion of a capital gain should not trigger CGT event E4 if the exempt amount arises due to the application of the small business 50% active asset reduction.

8) Franking credits and trust losses

When a trust derives franked dividends during the year, the franking credits attached to the dividends are included in the assessable income of the trust (refer to section 207-35 of the ITAA 1997). If the trust has a positive amount of trust income and taxable income for the year then the franking credits can be passed on to the beneficiaries of the trust (subject to the beneficiaries being qualified persons etc) and they can obtain a tax offset in relation to the franking credits.

However, if the trust does not have a positive amount of trust income or taxable income for the year then the franking credits received by the trust are effectively lost. They cannot be claimed by the trustee or any of the beneficiaries.

There is an additional penalty that applies in this case because even though no one is entitled to claim a tax offset for the franking credits, the credits are still included in the assessable income of the trust. For example, if the trust has tax losses for the year, the franking credits will reduce the tax losses that can be carried forward to later income years.

The Government should consider amending the provisions to allow a trustee to disregard the franking credits from its assessable income in situations where the trust has either no trust income or has no taxable income for the year.

9) Testamentary trusts

Testamentary trusts are commonly used for estate planning purposes. However, there is some uncertainty around the tax consequences of using these trusts and there are areas that could be clarified by amending the legislation.

a) CGT
Division 128 of the ITAA 1997 deals with the CGT treatment of deceased estates, including the impact of the rules on legal personal representatives (ie, executors) and beneficiaries. From an administrative point of view the ATO tends to treat the trustee of a testamentary trust in much the same way as a legal personal representative of a deceased estate (refer to PS LA 2003/12). Our view is that this position should be clarified in the legislation to confirm that no taxing point arises when assets pass from the trustee of a testamentary trust to a beneficiary (unless CGT event K3 applies).

CGT events E5 to E8 contain an exception so that they do not happen to a trust to which Division 128 applies. As above, the legislation should be clarified to confirm that this exception also applies to testamentary trusts.

b) Section 102AG
Division 6AA of the ITAA 1936 generally applies to ensure that unearned income derived by minors is taxed at penalty rates. However, there are some specific exceptions to this general rule. For example, subsection 102AG(2) treats certain trust income as 'excepted income' so that it is taxed at

normal adult marginal rates in the hands of minors. 'Excepted trust income' includes income of a trust that resulted from a will.

The main area of uncertainty in relation to these rules is whether the definition of 'excepted trust income' only applies to income derived from assets that originally passed to the trustee from the deceased under the terms of their will or whether it can also apply to income derived from assets that are subsequently acquired by the trustee or gifted to the trust.

In our view it is necessary to clarify the precise operation of this exception to provide certainty to both trustees and beneficiaries in relation to the tax treatment of income derived from assets held in a testamentary trust.

c) Franking credits
Beneficiaries of a testamentary trust are generally entitled to franking credits only if the trustee makes a family trust election or the beneficiary meets the $5,000 small shareholder exception. This may lead to unfair outcomes where a life interest in dividend income is left to a person who is not part of the family group of the deceased.

In March 2006 the Government announced changes to these rules so that beneficiaries of a testamentary trust, who have a vested interest in the dividend income of the trust but not the current beneficial ownership of the underlying shares, would be excluded from the franking credit holding period rules. However, legislation to make these changes was never introduced to Parliament.

In our view the Government should consider introducing the changes that were proposed in 2006 to exclude certain income beneficiaries of testamentary trusts from the franking credit holding period rules.

10) Small business CGT concessions

The consultation paper is silent on the potential impact of the reforms on the operation of the small business CGT concessions that are contained in Division 152 of the ITAA 1997. We are concerned about the continuing uncertainty in relation to the interpretation of some key concepts in Division 152 which involve trusts. In our view these concepts should be clarified as part of the current reform process.

For example, the small business CGT concessions use the concept of 'significant individual'. An individual is a significant individual if they have a 'small business participation percentage' of at least 20%. Items 2 and 3 of the table in section 152-70 define an entity's direct small business participation percentage by reference to the percentage of any distribution of income or capital that the trustee may make to which the entity would be beneficially entitled. The meaning of 'any distribution of income or capital' and 'beneficially entitled' is not defined in the legislation. While many taxpayers and their advisers adopt trust law principles in applying this test, there is continuing uncertainty in this area due to lack of guidance from the ATO.

Another example is the beneficiary control test under section 328-125(2) and section 328-125(4). For a non-discretionary trust, a beneficiary controls the trust if the beneficiary beneficially owns interests in the trust which entitle the beneficiary to receive at least 40% of any distribution of income or capital by the trust. For a discretionary trust, a beneficiary controls the trust for an income year if, for any of the 4 income years before that year, the trustee paid to, or applied for the benefit of, the

beneficiary at least 40% of the total of the income or capital paid or applied by the trustee for that year.

The meaning of 'any distribution of income' in section 328-125(2) and the meaning of 'the trustee paid to, or applied for the benefit of' in s328-125(4) already cause confusion in practice. The legislation appears to be inconsistent in applying the beneficiary control test for a discretionary trust as opposed to a non-discretionary trust. It is unclear whether the 'distribution of income' refers to income of a trust under trust law concepts or taxable income for tax purposes. It is also unclear whether the trustee needs to make a physical distribution of income or capital to a beneficiary for the purpose of section 328-125(4).

The small business CGT concessions in Division 152 are of vital importance to many SMEs. We are concerned that without proper consideration of the interaction between Division 6 of the ITAA 1936 and Division 152 of the ITAA 1997, any changes to the taxation of trust income could result in further confusion to taxpayers and their advisers when seeking to apply Division 152. We recommend that further clarity be provided in relation to the operation of Division 152 as part of the reform to the taxation of trusts.

11) When should present entitlement be determined for tax purposes?

As acknowledged in the consultation paper, it is often very difficult for trustees to make informed decisions regarding the appointment of income to beneficiaries by 30 June each year. Trustees are generally reliant on other parties (eg, accountants) to bring financial information up to date so that they can understand the implications of the distributions they are planning to make.

For example, the new streaming rules allow trustees to stream franked dividends or capital gains to specific beneficiaries by creating a specific entitlement in favour of those beneficiaries. From a practical perspective it can be very difficult for trustees to take advantage of these rules when it may take some months for their accountant to determine the franked dividends or capital gains that may have been derived by the trust during the year.

In our view, providing additional time for trustees to make resolutions regarding the distribution of trust income each year for tax purposes would alleviate many of the practical difficulties faced by trustees. An extended deadline of at least 3 months after year end would provide trustees and their accountants a reasonable period of time to prepare financial accounts while also enabling individual beneficiaries to obtain information in order to prepare and lodge their tax returns (subject to any specific requirements in the relevant trust deed). In our experience, many trust beneficiaries use a tax agent to lodge their individual tax returns so should generally be entitled to extended lodgement dates.

The consultation paper raises the possibility of having different dates for some kinds of trusts (such as closely held trusts) but notes that having multiple dates could increase uncertainty and compliance costs. In our view, having different dates for closely held trusts would not increase uncertainty or compliance costs. Closely held trusts are already subject to specific tax requirements that do not apply to other types of trusts (eg, trustee beneficiary reporting rules) and accountants and other advisors are used to having to identify and work with different tax obligations for different entity types.

12) Amendment period for trustees

We understand from the consultation paper that the Government is aware of the potential unlimited amendment period for assessments and amended assessments for trustees. While the ATO's administrative practice is to only issue an assessment to a trustee within 4 years from the later of the due date and actual lodgement date of the relevant return, our view is that a specific amendment period should be contained in the tax legislation.

Our view is that the amendment period for trustees should be consistent with the amendment period rules for other taxpayers. That is, a two year amendment period should apply if the trust in question is classified as a small business entity.

Also, the amendment period should not be dependent on an assessment being issued by the Commissioner to the trustee. Rather, the amendment period should be based on the actual lodgement date of the trust tax return.

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Thank you for your consideration of this submission. Should you have any queries then please do not hesitate to contact me at Michael.Carruthers@hayesknight.com.au.

Yours faithfully

Michael Carruthers
Director – Hayes Knight (NSW) Pty Ltd
On behalf of the Hayes Knight Group