The Institute of Chartered Accountants in Australia

16 February 2012

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

By email: trust_rewrite@treasury.gov.au

Dear Christine

Consultation Paper – Modernising the taxation of trust income – options for reform

The Institute of Chartered Accountants in Australia supports the government's initiative to improve and simplify the rules relating to the taxation of trust income and rewrite them into the *Income Tax Assessment Act 1997*.

The sharper focus placed by the Australian Taxation Office (**ATO**) on the taxation of trusts in recent years has put the spotlight on issues and practices which have existed for decades and, arguably, raised new issues. The uncertainty of the law, exacerbated by the complexity of the 2011 'interim fix', is of concern to taxpayers and tax practitioners alike.

The Institute therefore welcomes the opportunity to comment on the options for reform outlined in the abovementioned Consultation Paper. We also look forward to participating in the consultation process leading up to the introduction of new modernised legislation.

Annual statistics published by the ATO[1] indicate that there are over 600,000 taxpayer trusts in Australia. Their activities vary from relatively simple investment activities to the carrying on of mostly small businesses, including primary production activities. As a result, in assessing any model, not only do compliance costs need to be borne in mind but also the commercial ramifications if there is a shift in who pays tax between the trustee and beneficiaries in a greater range of circumstances than at present.

A large number of the trustees of these trusts will be advised by Chartered Accountants. The outcome of the review of the taxation of trusts will therefore impact on many of our members in practices varying in size from sole traders to the 'Big 4'. The Institute is therefore keenly aware that any modernised rules need to provide certainty through legislation which is relatively easily understood by all. Furthermore, any significant change to the current system will require sufficient lead time prior to commencement to allow an appropriate level of education for our members.

We are also cognisant that there are integrity issues which need to be dealt with appropriately.

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[1] Refer to http://www.ato.gov.au/content/downloads/cor00268761_2009CH6TRU.pdf, March 2011.

Our comments on the Consultation Paper are set out in the attached submission which comprises two parts:

- Appendix A – Response to the questions for consultation
- Appendix B – Detailed comments on the reform models.

However, we make the following observations in relation to the models themselves and the consultation strategy/indicative timeline for this reform project.

The proposed models

The Consultation Paper outlines three options for reforming the trust provisions - the Patch model, the Proportionate within a class (**PWAC**) model and the Trustee assessment and deduction (**TAD**) model.

The Consultation Paper describes the models in broad terms and uses simplistic examples to illustrate their operation. As a result, without doing our own modelling, it is impossible to say with confidence that any one model will deal with the issues in a way which appropriately balances the competing objectives. It is also difficult to conceptualise how a particular model, which appears 'simple' in theory, may translate to legislation. The 2011 interim streaming rules, while well intended, are an example.

With that background in mind, our initial preference is for the PWAC model provided that it can be legislated in a way which is easily understood. In part this is because:

- It is simpler than the Patch model. As we understand it, the Patch model would build on the existing rules as amended by the 2011 interim measures. Our feedback based on experience with these rules is that they are complicated and likely to be more so if amended to deal with the issues identified in the Consultation Paper.

- The TAD model is unacceptable because it will increase the likelihood of trustee assessments which attract a 46.5% penal tax rate, as well as the loss of many concessions such as the CGT discount and small business concessions. Moreover, it is unlikely to be simple when considered in detail as many of the existing problems, e.g. streaming and character retention, would still need to be addressed.

  The Consultation Paper does not address the impact on this model if accompanied by a reduction in the rate of tax for trustee assessments to, say, the 30% company tax rate. However, it would raise other issues, not limited to integrity measures to prevent income being accumulated at a 30% rate in the trust (similar to Division 7A of the *Income Tax Assessment Act 1936*) and rules to deal with subsequent distributions of trust income.

  More details and consultation are required if the TAD model is to be progressed, particularly the cost to the revenue if a reduced tax rate is considered to be an option.

- In contrast, and to a degree by default, the PWAC model has the potential to be implemented in a simple fashion taking advantage of concepts largely familiar to taxpayers and their advisers. However, as stated above – the detail of how this model is enacted will influence the success of this policy option.

Indicative timelines

The Consultation Strategy released at the same time as the Consultation Paper outlines the likely steps, and indicative timeframes, involved in developing an appropriate framework for the taxation of trust income and its conversion into legislation.

The timeline indicates that, subject to the scope of the review and broader government priorities, it is proposed that legislation be introduced in November 2012 for a target start date of 1 July 2013.

Given the complexity of the issues involved with the taxation of trusts and the large number of taxpayers and tax practitioners impacted by the proposed reforms, the Institute has a number of reservations in relation to the timeline and the consultation process itself. In particular:

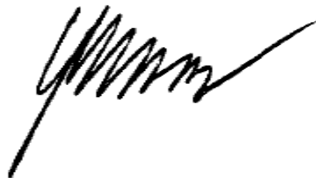
- Even if the reform process is staged with the focus of the initial phase limited to core issues, the targeted timeframe appears overly ambitious. The Institute is keen to end, as soon as possible, the uncertainty which has plagued the taxation of trust income for some years. However, we are equally committed to ensuring that the quality of legislation to emerge from this process achieves that objective in as simple a fashion as possible. We do not consider overly ambitious targets to be conducive to that outcome.

- In the event that legislation is able to be introduced in November 2012 without sacrificing its quality (which will be a challenge), a six month implementation period is unlikely to be sufficient for tax practitioners to understand the changes and the impact on their many clients which use trusts structures and whose trust deeds will almost invariably have to be reviewed if not amended. Regardless of when legislation is introduced, the appropriate lead time will depend on the extent and nature of any changes – both Treasury and the Government should bear this in mind when making final decisions about policy and timing.

- In relation to the consultation process itself, Treasury should consider the need to road test its preferred model in live cases. While this may be envisaged, the indicative timeline suggests otherwise. In our view, it is in the interests of government, Treasury, the ATO and the professions to ensure that we get this right and, ultimately, this will be the best test for determining the likely success of any new policy and legislation.

Should you wish to discuss our submission with us please contact Susan Cantamessa on 02 9290 5625.

Yours sincerely



Yasser El-Ansary
General Manager – Leadership & Quality
The Institute of Chartered Accountants in Australia

Appendix A

Response to the questions for consultation

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

Whether all of five policy principles outlined in Chapter 1 reflect the existing framework for the taxation of trusts is a moot point. Arguably, they reflect a mixture of current policy and the policy objectives of the proposed modernised rules.

However, subject to the comments below, they mostly do provide a useful framework for comparing the options for reform set out in the Consultation Paper.

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

In our view, this principle is not necessarily a feature of the way trusts are taxed under Division 6 of the *Income Tax Assessment Act 1936* (the **1936 Act**).

The amendments introduced by *Taxation Laws Amendment (2011 Measures No 5) Act 2011* (**TLAA No 5 2011**) have specific rules that appear to be designed with this principle in mind in relation to franked dividends and capital gains. In addition, the integrity measures in sections 100AA and 100AB attempt to match the cash and the taxable income that flows to tax exempt entities.

However, as illustrated by the examples in the explanatory memorandum to the abovementioned Act, the mismatch between cash and tax is pronounced for beneficiaries that are entitled to any remaining income, i.e. income other than franked dividends and capital gains that have been streamed.

In our view, in terms of this principle, anomalous outcomes will arise regardless of which model is adopted.

The Institute is concerned that the Patch model and the Trustee assessment and deduction (**TAD**) model appear to rely heavily on the 'follow the money' principle. Our concern is that while these models may seek to address anomalous outcomes for beneficiaries, it is the trustee that will bear the tax liability relating to any mismatch between cash and taxable income. Recent case law suggests that there will be situations where this will be detrimental to the revenue. Examples include *Cajkusic v FCT* 2006 ATC 4752 where, broadly, Part IVA applied to deny a deduction for a payment of $190,000 which was paid to an employee benefits trust. As a consequence, the liability for tax fell wholly on the trustee under section 99A of the 1936 Act. However, we understand that recovery of that tax liability was problematic because there were no assets in the trust and the trustee had been liquidated.

We are also concerned that strict adherence to this principle may require capital gains to be distributed by a trust. For either asset protection purposes or to maintain the investment capital of a trust estate, trustees may not wish to distribute capital gains that are not 'income' of the trust (as it may not always be considered to be in the interest of beneficiaries). As a matter of principle, tax should not negate the commercial reasons on which taxpayers based their choice to use a trust structure.

The provisions governing the taxation of trust income should be conceptually robust, so as to minimise both anomalous results and opportunities to manipulate tax liabilities

We agree that, *in principle*, the way in which the income of a trust is taxed should be conceptually robust both to minimise anomalous results and opportunities to manipulate tax liabilities.

The provisions governing the taxation of trust income should provide certainty and minimise compliance costs and complexity

We also agree that this is an important principle. There is no merit in replacing the existing regime for the taxation of trust income with a new system which is equally or more complex and brings with it a different set of issues.

However, in our view, what this and the previous policy principle do not expressly recognise is that there must be an appropriate balance – a system which is the most conceptually robust cannot be at the expense of simplicity and an acceptable level of compliance costs.

It should be clear whether amounts obtained by trustees retain their character and source when they flow-through, or are assessed, to beneficiaries

The Institute is of the view that this is a fundamental principle because many of the provisions in both Income Tax Assessment Acts are premised on the basis that income, gains and profits do retain their character and source.

Trust losses should generally be trapped in trusts subject to limited special rules for their use

We agree that this is a principle which currently applies to the taxation of trust income.
More generally, we note that the Business Tax Working Group (**BTWG**) has been tasked with advising the government on how the business tax system can be improved to enable business to make the most of changes in the broader economic environment. The focus of its interim report on the tax treatment of losses is businesses operating through a company structure. The BTWG acknowledges that whether the reform options outlined can be applied to businesses operating through other structures such as trusts will require further analysis.

Given that a large number of small businesses are conducted through a trust structure ultimately, as the Consultation Paper notes, "the principles underpinning any reform options might extend to trust losses (noting that not all trust losses are associated with business activity)".

The 'sixth principle' - revenue neutrality

Although not strictly a policy principle, the Consultation Paper indicates that the government remains committed to its fiscal strategy. Therefore, any changes made as part of the reform process have to be broadly revenue neutral.

It is apparent that this will operate as a constraint on the options available and, in particular, any option which, to gain any level of acceptance, would entail a reduction in the top personal rate of tax imposed on trustees on income accumulated within a trust.

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?

We agree that the areas in most need of immediate reform are, broadly speaking, those highlighted in the Consultation Paper[2]. These are:

- the interaction between the distributable income and taxable income of a trust[3];
- the method by which the taxable income of a trust is allocated to either the beneficiaries or trustee of the trust;

[2] Refer page 3.
[3] The dimensions of this issue may be impacted by a ruling currently being prepared by the ATO on the meaning of income of a trust estate.

- whether the amounts received by a beneficiary retain their character and source (and when 'streaming' of those amounts is effective for tax purposes); and
- the scope of Division 6 and other taxing provisions applying to trusts.

It is not entirely clear whether extending the time period in which the income of a trust must be allocated to beneficiaries is contemplated by the second dot point above. However, this is clearly another issue which should be addressed as a matter of priority. Ideally, it is considered that any proposed reforms include an ability to determine entitlements to income of the trust up to four months after year end, which would align with the earliest possible lodgement date for beneficiaries tax returns (31 October). However, we acknowledge that this may not be appropriate where a beneficiary is itself the trustee of a trust and that the default beneficiary clauses (contained in a large number of discretionary trust deeds) add to the complexity of any reform model.

There are likely to be other issues which are inherently related to these core issues which will also need to be considered at the same time.

As recognised in the Consultation Paper, other parts of the tax law may also need to be updated and rewritten to ensure that any changes made in these core areas operate effectively.

The Consultation Paper identifies a number of other areas identified by the private sector and the Australian Taxation Office (**ATO**) that would benefit from being updated and rewritten, including the fixed trust[4], trust loss and family trust rules contained in Schedule 2F. We agree that these are issues which need to be addressed

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?

Ideally, any proposed changes should be made in a single process.

However, given the magnitude of the exercise, at a practical level we see some merit in the reform process being conducted via a staged process. This recognises that:

- the trust provisions interact with other provisions, including the CFC provisions, the transferor trust rules and the managed investment regime which themselves are currently subject to a rewrite; and
- some of the rules relating to trusts, e.g. the trust loss rules and the family trust rules, are probably able to be considered at a later time.

However, if a staged approach is adopted, it is critical that an overarching framework be developed which recognises how the core trust laws to which priority is to be afforded are proposed to interact with other key provisions in the Income Tax Assessment Acts so that this is taken into account in the design of the core rules.

[4] As noted in the Consultation Paper, issues with the legislative definition of 'fixed trust' will be examined through a separate process.

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?

The Institute is of the view that:

- all trust relationships should be within the scope of Division 6 unless specifically excluded, i.e. an exclusion approach is preferred; and
- trust relationships to be excluded from the scope of Division 6 should be identified by way of general principle, subject to discrete references to a number of categories of trusts (see below).

This approach recognises that most trusts should be within the scope of Division 6. So, Division 6 should be the default position.

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?

It would be appropriate to exclude from the operation of Division 6:

- trusts which have their own regime or rules, e.g. the optional regime for managed investment trusts, trusts within the scope of Division 6C and trusts that are in a tax consolidation group; and
- trusts which it is appropriate to treat as 'transparent trusts' in the sense that the trust relationship is ignored and the tax consequences of the trustee's actions are taken to be the acts of the beneficiary(s) of the trust.

We acknowledge that, within Division 6, special rules may be required to accommodate certain types of trusts, e.g. testamentary trusts, deceased estates and trusts dealt with under international tax provisions such as controlled foreign trusts.

At a high level, we would expect transparent trusts to be trusts, other than unit trusts, which are effectively fixed. Typically, the property of the trust would be held solely for the benefit of an identified beneficiary (or beneficiaries jointly) where that beneficiary has a vested and indefeasible interest in the income generated from the asset. Where there are multiple beneficiaries the trustee would also not have the power to appoint income between beneficiaries.

Adopting exclusions along these lines would ensure that a wide variety of arrangements, which simply comprise the holding or ownership of specified assets for designated beneficiaries in fixed proportions, are excluded from the new trust measures. For example, it should ensure that the new trust measures should not apply to constructive trusts, equitable assignments, bare trusts, custodian arrangements, nominees, IDPS (investor directed portfolio services), IMAs (investor managed accounts) and SMAs (separately managed accounts).

If this approach is adopted for Division 6, the concept of 'absolute entitlement' in section 106-50 of the 1997 Act should be clarified at the same time. Ideally, Division 6 and the CGT rules should be aligned.

Other areas of the income tax law may need to be amended to ensure consistent treatment throughout the Income Tax Assessment Acts, or a general rule introduced which treats the beneficiary of a trust in these cases as holding the assets for their own benefit for all purposes of the Acts and ignores the existence of the trust. It will be important to ensure that trusts which are excluded from the operation of Division 6 are taxed appropriately under the remaining provisions of the Income Tax Assessment Acts.

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

No. In our view, existing tax principles would require that for tax purposes:

- expenses which relate directly to a particular class of income be allocated to that class;
- expenses which do not relate directly to any particular class of income be allocated to all classes of income on a reasonable basis; and
- revenue losses which arise in relation to a particular class of income should be allocated to all classes on a reasonable basis. Consistent with existing law, capital losses can be applied only to capital gains.

To the extent necessary, the explanatory memorandum could include examples of how existing tax principles would apply, particularly in areas where there are differences of opinion, e.g. whether general expenses should be allocated to capital gains. If appropriate, this could be supplemented by ATO guidelines.

If a legislative solution is considered necessary, existing tax principles would be an appropriate basis for developing such legislative rules.

The fact that, under a trust deed, a trustee has a discretion as to how to allocate expenses against different classes of income does not change our view.

In discussion, the example has been given of a trustee choosing to allocate expenses which properly relate to foreign source income to domestic income as follows:

Deed distributable income		
	Foreign source interest income $	**Domestic income $**
Income	100	100
Expenses		(50)
	100	50
Taxable income		
Income	100	100
Expenses	(50)	
	50	100

In our view, under the current law, no tax would be payable by a non-resident beneficiary on the foreign sourced income (assuming that the foreign income could be streamed). If the $50 of expenses properly relate to the foreign income, we believe that the principles established in *Ronpibon Tin NL v FCT* (1949) 78 CLR 47 would result in the Australian resident beneficiary being assessed on $100 of domestic income (assume $46.50 being the top personal tax rate).

The fact that the outcome in the above example does not 'follow the money' in the sense that the non-resident receives $100 but pays no tax (and the resident receives $50 but pays tax on $100) is not a matter which tax rules should seek to address.

In our view, the problem is one of trust law. If the Australian beneficiary considered that the trustee had not acted *bona fide* in relation to the allocation of expenses the appropriate remedy, if one is required, is to be found in trust law. We believe that, should Treasury attempt to address anomalous outcomes, it can only be at the cost of having unnecessarily complex rules.

If, however, the effect of classifying expenses differently for trust law purposes is to reduce the Australian tax payable then specific anti-avoidance rules may have a role to play.

If we have misunderstood or failed to fully appreciate the concerns of Treasury we would welcome your feedback.

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 do not believe that the concept of distributable income should be defined using tax concepts. We have a concern with a system that forces all trusts to fund distributions based on tax concepts.

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?

Character flow through and 'streaming' should be provided on a general basis with specific limitations where necessary to remove a beneficiary's ability to claim concessions related to that character of income, e.g. a company's ability to claim the CGT discount.

This would restore the position to that which existed prior to 30 June 2010.

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

As indicated in our response to question 6, revenue losses which arise in relation to a particular class of income should be allocated to all classes on a reasonable basis. Consistent with existing law, capital losses can be applied only to capital gains.

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?

Chapter 4 highlights the following areas of the tax law that may need to be updated to operate effectively if changes are made to the current operation of Division 6:

- the CGT provisions;
- the franked distribution rules;
- the consolidation provisions;
- the withholding tax provisions;
- Division 7A of the *Income Tax Assessment Act 1997*;
- the proposed new MIT regime'
- the TFN withholding rules; and
- the trustee beneficiary reporting rules.

Consideration may also need to be given to the public trading trust rules and international tax provisions including the transferor trust provisions, the CFC provisions and the foreign income tax offset provisions.

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?

As we understand it, there are some issues in relation to the interaction of Division 6 and the small business CGT provisions which we can elaborate upon during the course of the consultation.

We would expect that additional issues will come to light as the consultation progresses.

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?

Our initial view is that there should be one generic regime for trusts, other than those trusts which are subject to their own regime or are excluded from the operation of Division 6. To the extent necessary, special rules can be implemented to deal with specific categories of taxpayers (e.g. deceased estates and MITs which are not eligible or choose not to use the attribution method but which may access other aspects of the MIT regime).

In relation to the models outlined in the Consultation Paper we make the preliminary observation that the Consultation Paper is scant on detail in some areas and has used simplistic examples to illustrate their operation. As a consequence, our understanding as to what is envisaged may not accord with Treasury's view and our comments should be read in this context.

Of the three models outlined in the Consultation Paper, our initial preference is for the 'proportion within a class' (**PWAC**) model. In our view, this model could essentially be implemented by adopting the principles outlined in Taxation Ruling TR 92/13.

In our view a PWAC model, which does not involve a tax defined concept of distributable income, has the advantage of being more familiar to tax practitioners and other stakeholders and is far less complex than the 'patch' and TAD models.

Our comments on each of the models described in the Consultation Paper are set out in more detail in Appendix B.

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?

The Consultation Paper envisages that the PWAC model may require a definition of distributable income similar to the patch model, depending on the approach taken to defining classes of income. In particular, it indicates that a definition of distributable income is likely to be required where classes of income are determined with reference to the trust's deed as opposed to being embedded in the tax rules.

We do not understand these comments.

We do not see why distributable income would be defined under a PWAC model as being taxable income because:

- as outlined earlier, mandating the requirement to distribute taxable income for all trusts (i.e. especially those trusts where income is not defined as section 95 net income without any discretion to the trustee) is a matter of concern to us;
- related to this, the trustee may not be able to fund distributions to the extent taxable income (even if adjusted for notional amounts) would exceed what would otherwise be distributable income based on the trust deed;

- adopting the same concept of distributable income as in the patch model would make the provisions unnecessarily complex.

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?

We recognise the need to reduce the potential effects of the top marginal tax rate applying to unallocated amounts. Although the Consultation Paper acknowledges that this model 'may increase the scope for trustee assessments (although there may be options to address this), it does not elaborate on these options.

In our view, unallocated amounts might arise where trusts carrying on business wish to retain funds for working capital purposes, instead of the current mechanism of making distributions to corporate or individual beneficiaries and borrowing the distributions back.

The TAD model may be more acceptable to stakeholders if a reduced tax rate could apply (e.g. 30%) with top up/credit on distribution. Alternatively, a reduced rate could apply (35%) with no top-up.

We note that this might lead to consideration of integrity rules in relation to unallocated taxable income which is used by beneficiaries. We highlight that it would be inappropriate to apply Division 7A in its current form to a trust, because trusts might have significant accretions of untaxed capital and corpus. Therefore if an integrity measure was to be considered, it should only apply to the "taxed" reserves, to retain the capacity for the trust to be a conduit vehicle for all other amounts.

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

We see no reason why a distribution should be limited only to "cash only" distributions. We believe that a distribution should include the creation of present entitlements as well as cash distributions. We also believe that "East Finchley" type distributions should also be acceptable. We note that the 'company' model uses a concept of dividends and distributions, which are not limited to physical payments of cash.

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?

The extent of any transitional measures required will depend on the extent and/or nature of the changes. However, it is likely that consideration may need to be given to:

- delaying the commencement of the new rules (see additional comments below);
- providing a deduction for the cost of trust deed reviews and/or amendments required as a consequence of any changes;
- relieving taxpayers from adverse income tax consequences where trust deed amendments result in a resettlement of the trust, e.g. the occurrence of a CGT event, the disposal of assets such as trading stock or the loss of carry forward tax losses; and
- the states and territories providing relief from any stamp duty payable as a result of trust deed amendments.

In relation to date of commencement of the new rules, we note that, subject to the scope of the review and government priorities, the consultation strategy currently proposes that draft legislation be introduced in November 2012 for a 1 July 2013 start date.

This indicative time frame for introduction of the legislation is, in our view, overly optimistic. However, even if it is achievable, we have reservations as to whether a six month lead time before the new

legislation commences will be sufficient time for tax practitioners to understand the changes and to assess the specific impact on all of their clients which have trust structures.

In our view, depending on the nature and extent of any changes, the government should be prepared to consider:

- A deferred start date. This would allow time for tax practitioners to understand the new rules and ensure that, to the extent necessary, trust deeds for clients are reviewed and/or amended
- A 'soft start' date. In this case there could be a deferred start date with an option for trusts to elect into the new regime from an earlier date.

We are not aware of whether the indicative timeframe contemplates the 'road testing' of potential or preferred models in live cases. If not, given the large number of practitioners and trustees potentially impacted by the proposed changes, we urge Treasury to consider this approach.

Detailed comments on the reform models

Introduction

The Institute agrees with the policy principles of the proposed reforms to the taxation of trust income as outlined in Chapter 1 of the Consultation Paper, subject to our comments in response to question 1[5].

The Consultation Paper outlines three possible options for reform. These are the Patch model, the PWAC model and the TAD model. The Consultation Paper suggests that, in theory, each of these models has the potential to meet the policy principles of the proposed reforms.

In our view, the difficulty will be devising a model which strikes the appropriate balance between these policy objectives.

The Institute does not condone tax avoidance and appreciates the revenue concerns which the proposed reforms seek to address. However, because trusts are the most widely used vehicle by small business in Australia, we are particularly keen to ensure that the model selected provides certainty, is easily understood by tax practitioners and that compliance costs are kept to a minimum.

Our detailed comments on the three models are set out below.

Of these models, the TAD model reflects the greatest departure from the current system of taxing trusts. Furthermore, the TAD approach will result in an increase in the number of trustee assessments at the top marginal tax rate and the loss of most concessions, e.g. CGT discounts, small business concessions and franking benefits.

The TAD model is also unlikely to be simple when considered in detail. While a couple of examples have been provided in the Consultation Paper on the operation of the model, the examples do not consider the treatment of many items including timing differences, CGT concessions, imputation credits, amended assessments and over-distributions. Nor do they consider the outcomes which would arise over the full life-cycle of a trust.

As a result, in our view, the TAD model may result in a high degree of complexity for small business together with a high incidence of tax inequities.

Should the government favour a TAD model, we recommend that further consultation occur in relation to this approach prior to a firm decision being made.

In the light of our comments on the TAD model and our reservations in relation to the Patch model which are outlined in more detail below, at this stage the Institute favours the PWAC approach along the lines described below.

Proportionate within a class model

At this stage the Institute favours the PWAC model legislated in the same fashion as the now withdrawn TR 92/13W. We believe that this model will provide the simplest platform for re-writing the trust provisions into the 1997 Act.

Taxation Ruling TR 92/13 effectively achieved character retention and the ability to stream if taxpayers so chose. The ruling also outlined the treatment which would apply where a taxpayer did not stream (i.e. the mixed proportionate approach). During the 18 years that the ruling was in effect, taxpayers had certainty as to how to stream income and how character was to be retained.

[5] Refer Appendix A

If legislation could be drafted to reflect the approach adopted in TR 92/13W using broad principles rather than 'black letter law', we believe that taxpayers could effectively operate their trusts in much the same way as they did prior to 2011. This, of itself, would keep to a minimum the compliance costs associated with the reform/rewriting of the trust provisions.

A principle based approach to drafting provisions to embed character retention and streaming is our preferred approach for legislating TR 92/13W. This is because experience shows that 'black letter law' drafting, such as that adopted in the interim measures contained in TLAA No 5 2011, will result in very complex legislation under any approach.

Accordingly, we believe that a balance between certainty, compliance costs and integrity can be achieved if the principles to be applied in determining character retention and streaming were drafted in a manner similar to the way in which TR 92/13W was drafted.

We understand that Treasury is concerned with any model in which the trustee of a trust estate is able to influence the attribution of taxable income by exercising a discretion under the trust deed to determine the amount of the distributable income of the trust estate.

As indicated in response to question 7[6], we do not support a section 95 definition of income of the trust estate to deal with this integrity concern. Instead, we believe that appropriate rules could be introduced to deal with this issue. In essence, and at a very high level, in our view Treasury's integrity issues could be effectively dealt with if the term 'income of a trust estate' required the trustee to ignore:

- discretions that had been exercised by a trustee to treat income as capital;
- the raising of certain expense provisions; and
- fixed definitions of income (e.g. $10).

The Patch model

The Consultation Paper states that "[t]he 'patch' model is arguably the least intrusive way to update the operation of Division 6. It involves retaining the existing structure of Division 6, but defining the term 'income of the trust estate' for tax purposes".

Conceptually, the Patch model has certain merits because it would remove any reliance on an individual trust deed to determine a beneficiary's share of the 'income of the trust estate'.

The Consultation Paper states that submissions received in response to original discussion paper indicated that the preferred approach to defining the term 'income of the trust estate' as part of a 'patch' model was to use tax concepts. However, it is important to note that these submissions were written before the introduction of TLAA No 5 2011 which introduced interim measures for streaming income and certain integrity provisions around trust distributions to tax exempt entities.

The integrity measures, contained in section 100AA and section100AB, are incredibly complex. Similarly, the streaming rules introduced by TLAA No 5 2011 are equally complex. The complexities in relation to the streaming rules result from seeking to ensure that the economic benefits associated with franked dividends and capital gains effectively flow to the beneficiary.

Our understanding is that practitioners now consider that the existing streaming rules are overly prescriptive and unnecessarily complex. The rules also result in skewing all of the anomalies to the beneficiaries that receive any other income (i.e. income other than franked dividends and capital gains). We refer you to the comprehensive examples in the Explanatory Memorandum which accompanied the Bill which illustrate this point.

[6] Refer Appendix A

We suggest that, with the benefit of hindsight, aligning the distributable income of the trust with the taxable income of the trust is likely to result in complex rules. An even greater concern is the funding issues this creates.

All three options have the potential to shift some or all of the tax liability in respect of the taxable income of a trust to the trustee. That shift is more likely to occur where the trust's taxable income is greater than the deed distributable income. More often than not this situation arises because of fiscal fictions that produce notional assessable income or the denial of deductions because, for example, the expenditure is capital in nature.

In our view there is a danger that, by seeking to align distributable income with taxable income, trustees will increasingly be required to fund requisite distributions to beneficiaries or its own tax liability (in the event that the trustee is assessed) when it does not have the capacity to do so.

For example, looking at the requirements of section 100AB, we would expect that a trustee would be assessed on any permanent or timing differences which cause the taxable income of a trust to exceed the amount that is legitimately available for distribution.

The facts of the example in Appendix 1 of the Consultation Paper under the TAD model illustrate this point.

In that example, the taxable income of the Deakin Trust of $50,000 exceeds the amount available for distribution. This is because the trustee incurs an expense that is not deductible. The profit and loss statement of the Deakin Trust is as follows:

Business income	50,000
Less: legal expenses	(40,000)
Trust income	10,000

The trustee therefore only has $10,000 cash to distribute. However, if under the patch model the distributable income of the trust was taken to be the taxable income, the trustee could only distribute $10,000 to the beneficiary (i.e. 20%). Presumably, the trustee would be assessed on the remaining 80%, at the (currently) top marginal rate of tax. Given that the $40,000 has been paid to the law firm that provided the legal advice, the trustee may not have the capacity to fund the tax liability.

We understand that under the current operation of Division 6 there is significant scope for anomalous outcomes and possible tax manipulation due to mismatches between the terms 'income of the trust estate' and 'net income of the trust estate'. As the above example illustrates, anomalous outcomes will continue to arise where the distributable income of the trust is aligned with the trust's taxable income.

Treasury's concerns in this regard could be addressed in the same way as discussed above in relation to the PWAC model.

Trustee assessment and deduction model

While, in theory, the TAD approach may have some appeal, we are concerned that the approach has not been adequately considered or tested. The Consultation Paper has insufficient detail regarding how the model would work in practice. The lack of detail makes it difficult to project the implications of the TAD model over the lifecycle of a trust.

We provide a few examples in the following sections of issues that we believe would need to be more thoroughly considered and consulted upon in respect of the TAD approach.

- *Compatibility with trust deeds*

  Little consideration appears to have been given to whether trust deeds will be able to comply with the proposed TAD model, the changes that may be required to trust deeds and the consequences of such changes. Given that there are over 660,000 trusts in existence, we believe that this is a critical first step before considering the implementation of the TAD model.

- *Commercial issues*

  Treasury would also need to appropriately consider the commercial issues associated with introducing a TAD approach. For example, trustee assessments may result in many trusts breaching their banking covenants and cause financing issues for small business taxpayers. Trustee assessments may also require trustees to use trust assets to fund tax liabilities.

- *Trustee assessments*

  We are concerned with the increased number of trustee assessments that could arise under a TAD model, especially where the trust deed does not define distributable income as section 95 income. At this stage, there are no real proposals contained in the Consultation Paper that would deal with this issue. Furthermore, while the proposed reform is intended to be ‘revenue neutral’, a greater number of trustee assessments would clearly result in additional revenue to the government and higher costs to small business taxpayers. In our view this is not appropriate.

- *Loss of concessions*

  In addition to a greater number of trustee assessments, most (if not all) of tax concessions are not available where a trust accumulates income. For example, the trustee is not entitled to the CGT discount of 50% and many of the small business concessions are also not available. The franking credit offset would also be wasted, given that the 30% offset would be applied against a top marginal tax rate.

- *Amended assessments and over-distributions*

  We do not believe that the consequences of amended assessments have been tested appropriately, especially where the adjustment relates to a timing or permanent difference. We are concerned that, where income has been distributed (incorrectly) in one income year based on an incorrect (pre-amended) calculation of taxable income, the model does not subsequently recognise that distribution in the amendment year. Accordingly, we believe there will be a significant number of cases where the ‘follow the money’ principle will not be satisfied.

- *Trust to trust distributions*

  We are unsure how the TAD model will deal with trust to trust distributions and how the receiving trust will be able to calculate and on-distribute the amount to its beneficiaries.

In summary, the move to a TAD approach would be a radical change for trust taxation and one that the government should not commit to without further testing.

Accordingly, in the absence of further testing and public consultation, we cannot support a TAD approach.