The Institute of Public Accountants

Modernising the taxation of trust income – options for reform

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Partnership beyond numbers

IPA INSTITUTE OF PUBLIC ACCOUNTANTS

Introduction

The IPA welcomes the opportunity in providing a submission to Treasury on the consultation paper **"Modernising the taxation of trust income – options for reform"**. Current taxation treatment of trusts has created much uncertainty which has had a detrimental impact on compliance cost and is long overdue for change.

Trusts represent important structure in the Australian tax system. The review of the current tax treatment of trusts is an important development and can potentially impact on businesses and individuals operating through trust structures.

The IPA is one of the three professional accounting bodies in Australia, representing over 22,000 accountants, business advisers, academics and students throughout Australia and internationally. The IPA prides itself in not only representing the interests of accountants but also small business and their advisors. The IPA was first established (in another name) in 1923.

The IPA's submission has been prepared with the assistance of the IPA Faculty of Taxation. We are grateful for their contribution and guidance. The IPA submission has also benefited from consultation with IPA members who have expressed their views and concerns. We are also grateful to all those who have taken the time to provide their input.

We look forward to discussing further and in more detail the IPA's recommendations with the Government and Treasury.

Please address all further enquires to:

Tony Greco tony.greco@publicaccountants.org.au

Yours faithfully

Tony Greco

Senior Tax Adviser

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Executive Summary

The IPA has long advocated for a review of the trust income tax provisions in Division 6 of Income Tax Assessment Act 1936 (Division 6). The interaction of trust law and the income tax treatment of trusts has been an ongoing issue for some time. Whilst Division 6 has been in place for some time, recent Court decisions have created much uncertainty in its application requiring legislative clarification. The need for reform has recently been heighten in the High Court's decision in Commissioner of Taxation v Bamford (Bamford) and by Australia's Future Tax System Review (Henry Review). The Henry Review recommended that the trust rules be updated and rewritten to reduce complexity and uncertainty around their application.

The IPA cannot stress enough the importance of the review to its members. Trust structures have been used as a vehicle for holding wealth mainly due to their asset protection and succession planning advantages. They are also commonly used by small business to carrying on a business or for investment purposes or a combination of both. Trusts were used almost exclusively to hold passive investments but have over the last two decades become a common structure for small business to house their trading business. The outcomes of the review will therefore have implications for the 660,000 trust already in existence.

We commend the Government for undertaking a broad review of the trust income tax provisions and making good it's undertaking to an extensive public consultation process. The timetable for the review allows stakeholders to have an opportunity to express their views before any final decisions are made about how to update and rewrite the trust income to achieve optimum legislative outcome.

We are also heartened by the opening comments in the consultation paper that the review is not intended to be a crack down on the use of trusts. Also reassuring is the acknowledgement that trusts are a legitimate structure through which taxpayers are able to conduct their personal and business affairs. Recent events have increased uncertainty and have had a detrimental impact on compliance costs for the 660,000 or so taxpayers that use a trust structure. IPA prides itself on representing the interest of small business wants to see increase in certainty and a reduction in compliance costs for the many hundred of thousands of small and family businesses that use trusts.

The indicative timetable for the update and review proposes to introduce the legislation into Parliament in November 2012, for a July start date of 1st July 2013. The IPA is concerned that this may be an unrealistic timetable, unless the minor tune up option is chosen (retain existing model in Division 6 with improvement to fix known problems and clarify uncertainties). If another model is to be adopted requiring substantial changes, then given the complexity of the issues to be surmounted, we believe a longer lead time for its introduction is required. There are a wide variety of trusts differing in their deeds, structure, use and size which will require deeds to be reviewed and possibly changed as a result of legislative changes. There will be also be a need to educate trustees ahead of the implementation timetable. Given the number and diversity of trusts in existence, an extensive education process over several months will also be required.

Introductory comments

The consultation paper has summarised the key issues impeding the effective taxation of trusts. It has also outlined the broad policy framework for the review and some policy options for reform. The paper leaves open the issue of character flow-through and streaming which we consider fundamental attributes of trusts which have been challenged in recent judicial interpretations. The IPA would have liked more guidance on the acceptance of character flow-through and streaming in considering the various reform options. These features have become accepted practice over time and should be retained as part of the broad policy framework in which to conduct the update and review. We would hope that character flow-through and streaming issues are sorted out sooner rather than later during the consultation process.

Our submission concentrates on the main issues affecting small practitioners servicing clients who use trust structures for a variety of reasons. Our primary objective is to reduce the unnecessary compliance and administrative costs which have arisen as a result of the current taxation provisions. Also of prime importance is to ensure that the existing attributes of trust remain intact and are protected for existing trusts.

Determining present entitlement by year end

Trustees must resolve to make beneficiaries presently entitled to the trusts distributable income by the 30th June. The inflexibility with respect to this legislative requirement has caused considerable administrative impracticality for trustees and their accountants for some time. Whilst we recognise the need for some deadline for determining which beneficiaries should be assessed on a trust's taxable income, the current arrangements are impracticable. As highlighted in the consultation paper, difficulties arise largely because all of the relevant information about the trust's accounts is not available at the time resolutions are required.

To mitigate the issues with the end of year deadline for determining present entitlement, the ATO issued Income Tax Ruling IT 328 (IT 328) in May 1966, which provided trustees until 31st August to exercise their discretion to pay or apply the income of the trust to beneficiaries. Whilst this ruling provided an administrative solution, the recent case law decision in *Colonial* First State Investments Ltd v Commissioner of Taxation (Colonial decision) confirmed that this administrative solution was not supported by the operation of the current tax trust rules.
Moreover, any such practice would not enable trustees to ignore entitlements already created at trust law — for example, as a result of default beneficiary clauses

(which were not in wide usage when the ATO's administrative solution was developed).

In light of recent case law decisions such as the Colonial decision, the ATO had to withdrawn this ruling with effect from the 2011-12 income year. The withdrawal of IT 328 has served to emphasise the inflexibility of the legislative requirement that entitlements must arise by the end of the relevant income year, as well as the administrative impracticality that this may present for trustees.

The short term amendments to enable the 'streaming' of capital gains and franked distributions post Bamford decision that were enacted in *Tax Laws Amendment (2011 Measures No.5) Act 2011* (TLAA No.5 2011) recognised this issue. These amendments allowed for a capital gain, a two month period after the end of the income year to record the beneficiary's entitlement in the trust's accounts or records.

Not so for a franked distribution. A beneficiary's entitlement must be recorded in the trust's accounts or records by the end of the income year in which the distribution is received. The ATO however had an administrative arrangement, for the 2010-11 income year only, to extend this deadline to 31 August 2011 to make beneficiaries presently entitled to a franked distribution. No such concession applies for the current 2012 income year highlighting legislative inflexibility.

Any rewrite must address this administrative impracticality with respect to the timing requirement for present entitlement.

Character flow-through

The concept that the character of amounts in the hands of a trustee is retained when those same amounts are distributed to the beneficiaries of a trust has been an accepted feature of trusts for some time. This concept commonly referred to as the conduit principle, has been a widely accepted perception of how trusts operate.

Whilst we acknowledge that character retention can be particularly advantageous if there are specific provisions in the trust deed that allow attribution of amounts with specific tax characteristics, it is particularly important to embody this conduit theory as part of the re-write.

Without character flow-through, beneficiaries could miss out on a number of Government initiatives and there is no policy reason why beneficiaries who receive income indirectly through a trust should be disadvantaged. The consultation paper draws attention to the fact that conduit principle finds support in case law but the matter is subject to ongoing judicial interpretation and is not beyond doubt.

Capital gains provisions and dividend imputation rules rely on the conduit theory and there are specific provisions in the tax law that attribute specific tax characteristics to these amounts. The broader issue of character retention needs to be re-affirmed in the re-write to cover amounts not covered by specific provisions in tax law that attribute specific tax characteristics to certain amounts.

The IPA endorses the proposal that there should be a generic rule providing for character retention for amounts received through a trust. If appropriate, this general rule could be limited by more specific provisions that remove a beneficiary's ability to claim concessions related to that character of income if required.

Streaming

The ability to 'stream' income has been an important feature of trust structures for some time. The term 'streaming' refers to the ability of a trustee to direct different types of income to different beneficiaries of a trust. Under a flow-through approach to the taxation of trusts, certain amounts in the hands of the trustee are treated as retaining their character in the hands of beneficiaries. Where these amounts are able to be 'streamed', trustees can determine the specific types of income appointed to specific beneficiaries.

Before the High Court's decision in Bamford, the practice of treating trusts as flow-through vehicles, either generally or subject to the terms of the trust deed, was widespread.

There remains confusion about whether 'streaming' of particular types of income, profits or gains to particular beneficiaries is effective for tax purposes.
Following the High Court's confirmation of the 'proportionate approach' in Bamford, taxpayers and their representatives expressed significant concern about whether it was still possible to stream amounts or whether a beneficiary is assessed on a proportionate share of a 'blended' amount of the trust's taxable income.

After receiving advice from the Board of Taxation, the Government in order to provide certainty introduced specific provisions in TLAA No.5 2011 to ensure that, where permitted by the trust's deed, capital gains and franked distributions could be effectively 'streamed' for tax purposes.

On the basis that character retention is maintained, we see no reason why there should be any restriction on the ability of trustees to stream. As noted above, specific provisions could be introduced to remove the beneficiary's access to concessions attached to that income where appropriate if this is required.

One size fits all approach

Given the wide variety of trusts, it may be prudent in the policy design review stage to recognising different categories of trusts and treat these in different way to other trust. The IPA gives strong support for recognising different categories of trust and treating these in different ways. Some overseas jurisdictions have adopted this approach, which we believe warrants some serious consideration.

A similar process has already begun for managed investment trusts (MIT's) which will have their own tax regime. A similar process could be adopted for fixed trusts or other categories of trusts that are unique enough to warrant more targeted tax rules reflecting their individual characteristics. We understand that this can create complexity, (border rules and entry/exit issues) but if there are clear rules about the different categories of trusts this could mitigate some of the potential problems.

Alternatives to the proportionate approach for taxing beneficiaries

As well as addressing specific issues impeding the effective operation of Division 6, the consultation paper considers whether a new model should be used to tax liabilities to beneficiaries. The proportionate approach has been accepted practice used for taxing beneficiaries. Practitioners have become familiar with this approach whereby the beneficiary's share of income of the trust determines their share in the taxable income of the trust on the same basis.

The proportionate approach however can produce anomalous outcomes, which can lead to unfair tax impost on beneficiaries. It can also result in tax being avoided by directing assessable income to exempt beneficiaries, without the full entitlement to the trust income. The alternative is the quantum approach which allocates taxable income to a beneficiary based on the (quantum) amount of their entitlement to trust amounts that relate to taxable income. The key advantage of the quantum approach is its simplicity and straightforwardness. This approach however increases the likelihood of unallocated amounts especially in cases where the taxable income of a trust exceeds its distributable income.

The current treatment of unallocated amounts makes the quantum approach unattractive. Under the current law, unallocated amounts are assessed to the trustee typically at the top marginal rate (plus Medicare Levy). Subsequent distributions of these amounts are generally not taxable.

If unallocated or retained amounts are taxed at relatively high rates as is currently the case, there is a strong incentive for trustees to ensure that beneficiaries are entitled to all of the trust's income each year. This tax treatment ensures that trusts are effectively used as flow-through vehicles even though the actual 'cash' within the trust may not actually be paid out to the relevant beneficiaries for a number of years.

Alternatively, if the trustee were taxed at a lower rate (i.e. corporate tax rate) than the top marginal rate when some of the income is accumulated in the trust, there would be less incentive for the trustee to ensure that beneficiaries were made entitled to all of the trust's income. This tax treatment would increase the scope for trusts to be used more like accumulation vehicles, with amounts being taxed to the trustee and retained for use within the trust.

The IPA would ideally like the option of trusts to be able to accumulate unallocated income. If budgetary considerations do not permit such a change in policy, then a more favourable tax rate than the current regime would be a positive outcome. Alternatively only the difference between distributable trust income and trust taxable income which results in an amount of unallocated income is taxed at a more favourable tax rate. Any of these outcomes would improve the quantum approach and are worthy of consideration.

The consultation paper outlines three possible alternatives to taxing trust beneficiaries. They are a patch model, proportionate within class, and trustee assessment and deduction model (TAD)

Our brief thoughts on each model option are as follows:

Patch Model

This model involves retaining the existing structure of Division 6, but defining the term ‘income of the trust estate” for tax purposes to improve the operation of the proportionate approach under the existing arrangements. The paper canvasses three options for defining above term namely: (i) tax concepts, (ii) accounting concepts (iii) retain current approach relying on general trust law. Based on previous submissions on an earlier discussion paper on the topic released last year, the preferred option was to use tax concepts. This model could create issues for trust deeds without flexible income definitions where trustees do not have the option to equate income of the trust estate with the trust’s taxable income.

A proportionate within a class

This model operates in a similar way to the current present entitlement model with an additional step to ascertain the classes of income and the proportionate entitlement in relation to these classes. This model would seek to codify the ATO’s administrative practice that was provided up until 30 June 2010 before it was withdrawn due to Bamford decision. Taxation Ruling TR 92/13 issued by the ATO allowed a proportionate approach to be applied within the various classes of income of a trust. Given that this ruling had been in existence for over 18 years it had become accepted practice and was reasonably well understood.

The treatment of losses under this model would need further consideration, in particular how to treat losses at a class level if a proportionate within class model was adopted.

Trustee assessment and deduction model (TAD)

A TAD model is one where the trustee of a trust is assessable on the income they derive but a deduction is provided to the trustee for distributions it makes to the beneficiaries of the trust. It effectively taxes the taxable income of a trust in the hands of those beneficiaries that receive the economic benefits related to that taxable income. Assessable amounts not distributed are taxed in the hands of the trustee. If the trustee distributes all of the taxable income no tax is payable by the trustee.

The distributions made by the trustee are then taxable in the hands of the beneficiaries who receive the distributions. The model is effectively a ‘quantum approach’ based on distributions of taxable income rather than a concept of

‘entitlement’ to income. As the distribution would be linked to the assessable income of the trust, the distribution would also be tagged with a tax character allowing full character flowthrough.
Under this model trustees will only be assessed on taxable amounts that are retained in the trust. The definition of a distribution under this model will therefore, be critical. If actual ‘cash’ distributions are likely to be required for the trustee to obtain a deduction, this could impose financing difficulties for SME businesses unless unpaid distributions are also allowed (i.e. as is the case with companies and dividends).

The consultation paper does not address the issue of subsequent distributions by trustees of unallocated amounts which have already borne a level of trustee tax.

The TAD model has the potential to reduce complexity and compliance costs to determine the tax liabilities of the beneficiaries and trustees of the trust and warrants further investigation. The attraction of the TAD model would be further enhanced if the rate of tax paid by the trustee on unallocated amounts was struck at a rate lower than the present highest marginal tax rate. Similarly if beneficiaries received favourable tax treatment for subsequent distributions by trustees of unallocated income in which tax has already been borne at trustee level. Favourable tax treatment in the form of a tax offset without having to resort to an imputation system as applies to dividends would enhance the appeal of the TAD model. If more favourable tax treatment was limited to only differences between trust distributable income and taxable income, then this would limit the cost of such a proposal and discourage trust being used as accumulation vehicles.

Transitional Relief

In the advent that taxpayers are disadvantaged with the way trust will be treated going forward, there should be some consideration for transitional relief allowing taxpayers to move to another structure without tax implications. Taxpayers who have already established trust structures in good faith may want the opportunity to move to a different structure if the changes result in adverse outcomes.

Contact

IPA Head Office

Level 6, 555 Lonsdale Street
Melbourne Victoria 3000
Australia

Tel : 61 3 8665 3100
Fax: 61 3 8665 3130
Email : natoffice@publicaccountants.org.au
Website: www.publicaccountants.org.au/

IPA Divisional Offices are located in the following cities:

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