

18 December 2011

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

Email: trust_rewrite@treasury.gov.au

Dear Sir or Madam

MODERNISING THE TAXATION OF TRUST INCOME SUBMISSION

I refer to the opportunity to provide feedback and comments on the issues outlined in the consultation paper *Modernising the taxation of trust income – options for reform*, and provide my views in this letter. As a practitioner providing accounting, tax and advisory services to small and micro businesses, and to individuals, my suggestions are based on the simplification of the taxation system and the minimisation of administrative red tape endured by the smaller end of the tax spectrum.

The areas that I have commented on are, in summary, as follows:

- Codification of character retention for amounts received through a trust
- Codification of streaming of amounts to beneficiaries
- Treatment of income tax losses
- Reform of the Division 7A provisions to reduce compliance costs

My detailed comments on the above issues are provided in the following pages.

Thank you for the chance to provide my views regarding opportunities for further tax reform.

Yours faithfully

KERRO CONSULTING PTY LTD
A.B.N. 46 114 774 542

Scott Kerrison

SCOTT KERRISON
MANAGING DIRECTOR

Codification of character retention for amounts received through a trust

The general nature of trusts should indicate that there should be character retention for amounts received through a trust. As a trustee only ever holds assets and derives income on behalf of a beneficiary, it is unclear how the intention for anything other than character retention could be argued; and the consultation paper makes no such clear argument, other than to note uncertainty in practice. The uncertainty noted in section 3.5 of the consultation paper would appear to arise as much from the judicial interpretation of poorly worded legislation than it does from an underlying principle.

Recommendations: The tax law should provide a generic rule providing for character retention for amounts received through a trust. This will clearly resolve the uncertainty referred in the consultation paper.

Codification of streaming of amounts to beneficiaries

Consistent with the recommendation made above with regards to character retention, amounts streamed to a particular beneficiary should retain their character in the hands of the beneficiary (subject to appropriate provisions in the trust deed allowing for the streaming of amounts and appropriate record keeping).

The Government has already seen it fit to introduce legislation (Tax Law Amendment Act No.5 2011) to appropriately interact with Division 6; noting specifically the 'streaming' changes introduced for amounts to which a beneficiary is 'specifically entitled' with regards to capital gains and franked distributions.

At a minimum, the 'specific entitlement' provisions should be extended to include foreign income, which, like capital gains and franked distributions, provides unique differences from more mundane classes of income, such as interest income or gross rental receipts.

However, I believe that such a streaming entitlement should be extended as a general principle to any class of income that the trustee may separately identify and maintain records for; subject to streaming of class income being consistent with the provisions of the relevant trust deed.

Recommendations: The tax law should provide clear acknowledgement of a trustee's entitlement to stream different classes of income to different beneficiaries (subject to the trust deed allowing for such streaming), as the trustee determines.

Treatment of income tax losses

Consistent with the recommendation made above with regards to streaming of amounts to beneficiaries, income tax losses should, at first review, be allocated against the income classes for which they were first incurred.

This will be a matter of each trustee maintaining a record (which should not be required to be lodged with the Australian Taxation Office) of the class of income for which losses have been incurred.

In the event that income tax losses from a prior year exceed the income from that class in the current year, any remaining income tax loss would need to be allocated by the trustee as they determine against any other classes of income before an income tax loss is carried forward into a future year.

This would mean that income tax losses of one class are not carried forwarded to a future year while income profits of another class are distributed in the current year.

Recommendations: Trustees should allocate income tax losses incurred by a class of income against that same class of income in future years. Where there are remaining income tax losses after offsetting against that class income, those losses would need to be allocated against income of other classes (apportioned between classes as determined by the trustee) before any remaining net income tax losses being able to be carried forward to a future financial year.

Reform of the Division 7A provisions to reduce compliance costs

Division 7A was inserted into the Income Tax Assessment Act 1936 with effect from 4 December 1997 on the basis of providing an integrity measure against (essentially individual) taxpayers accessing profits taxed at the corporate income tax rate without paying any additional (higher) tax rate that may have applied to them had those profits been distributed directly to the individual. These provisions were extended to interact with trusts with effect from 27 March 1998 where loans were made by a trust that had unpaid beneficiary entitlements owing to a corporate beneficiary. Despite an original intention to prevent access to funds by individuals in higher marginal tax brackets than the corporate income tax rate, the provisions in fact extend to the provision of funds to almost any individual or entity.

Each taxpayer should be entitled to decide whether to call in unpaid beneficiary entitlements, the period of repayment for any loans provided, and the basis for how much, if any, interest is charged on loans outstanding, without undue interference or impact by the Government through the tax system.

Although changes have been made to the Division 7A provisions in recent years to reduce their punitive impact, particularly for inadvertent breaches, the Division 7A rules retain their administrative complexity that contributes to small business and investment entities continuing to require the services of professional tax agents, detailed review of accounts and transactions, and the establishment of carefully worded loan agreements within family groups (often essentially made between a single individual acting in various capacities, whether as an individual taxpayer, the sole director of a private company or as the trustee of a discretionary trust).

While the separate legal structure of each entity must be acknowledged and respected, small business owners operate on a pool of funds to a greater extent than larger business. If the Government truly believes that small business is the great generator of jobs in this country, then we should be reducing impediments to owners spending their time on the business rather than trawling through administrative complexities of the tax law.

To address the particular complexities imposed on trusts (but also imposed on taxpayers more broadly) by Division 7A, entities should be allowed to move funds around a family group that is subject to valid family trust elections / interposed entity elections being in place (which would effectively apply a consolidations approach to Division 7A). To maintain the policy intent of individuals not accessing funds only taxed at the corporate income tax rate, this proposed consolidations treatment would only extend to non-individual taxpayers.

Recommendations: An exception to the application of the rules within Division 7A should be provided that allows for payments, lending and debt forgiveness within the entities of a family group that are subject to family trust / interposed entity elections; with the existing rules retained as they relate to individuals.