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Our Ref
JD/WQ 114472
Your Ref

Date
8 February 2012

Also by email: trust_rewrite@treasury.gov.au

Dear Sir

TRUST RE-WRITE CONSULTATION PAPER
SUBMISSION REGARDING CAPITAL PROTECTED TRUSTS & CGT

We write in response to the Government's Consultation Paper entitled *Modernising the taxation of trust income – options for reform* dated November 2011 ("the Consultation Paper").

The purposes of this submission are to:

1. Draw the Government's attention to the particular category of Capital Protected Trusts, and to request that the tax treatment of capital gains in these trusts be addressed as a matter of priority in the reform process;

2. Draw the Government's attention to specific issues arising out of the present operation of the *Tax Laws Amendment (2011 Measures No. 5) Act 2011* ("the Trust Streaming provisions") in relation to capital gains in trusts generally; and

3. Propose a possible solution to the problems raised in this submission, being the option to all trustees to accumulate capital gains whilst still retaining access to the various capital gains tax ("CGT") discounts.

In this cover letter, we summarise the key reasons behind our submission, and we set out our more detailed reasoning in the enclosed Annexure.

Reasons for Submission

1. Capital Protected Trusts are trusts, the terms of which provide for a separation between the income beneficiaries and the capital beneficiaries of the trust. Whilst there might be some overlap between the two classes of beneficiaries, they are not identical.

2. Further, the interests of the capital beneficiaries are very often either contingent or deferred rather than vested. Two very common scenarios are:

    a. Trusts in which the capital beneficiary is determined from the outset, but the trustee's powers to distribute capital to that beneficiary is deferred until such time all of the income beneficiaries have died or consented to a capital distribution; and

    b. Trusts in which a class of capital beneficiaries must survive until the death of the income beneficiary before they have any entitlement. This is most common in life interests established by Will.

3. Settlors and Willmakers usually establish this division between income and capital beneficiaries, and these restrictions upon the distribution of capital, specifically for non-tax driven purposes. More specifically, their purpose is usually the government sanctioned purpose of family provision, most usually provision for minor beneficiaries who have suffered a loss that falls within one of the scenarios outlined in section 102AG of the *Income Tax Assessment Act 1936 (ITAA 1936)*, or for the spouses and children of a Willmaker in complex estate planning scenarios. The most common types of Capital Protected Trusts with which we are concerned are:

    a. Excepted Proceeds Trusts that comply with section 102AG(2) of the *Income Tax Assessment Act 1936 (ITAA 1936)* – these trusts are funded by proceeds arising out of the death of a child's parent, the injury to a child, or a breakdown in a child's family, specifically for the purpose of providing for the child; and

    b. Life interests established by Will – these are most frequently established to ensure that the spouse of the Willmaker is provided for during his or her lifetime, and at the same time to protect the capital of the estate for the Willmaker's children. Alternatively, they are established for beneficiaries who are financially vulnerable due to circumstances such as drug addiction, mental illness or other physical or intellectual illness or disability, who may not necessarily fall within the scope of the Special Disability Trust requirements.

4. It is our submission that the current legislation governing the taxation of trusts, and in particular the CGT provisions in subdivision 115-C of the *Income Tax Assessment Act 1997* ("ITAA 1997") ("CGT provisions"), including the Trust Streaming provisions, operate to effectively discriminate against Capital Protected Trusts. This is because the present taxation regime operates to either:

    a. Tax the income beneficiaries on capital gains in respect of which they have not received, and often cannot actually receive any benefit; or

    b. Where the intent of the trust is to be upheld, tax the trustee on the capital gain at what is effectively at a penalty rate, in that the trustee is denied access to any of the CGT discounts, and is then taxed on the entire gain at the top

marginal rate plus Medicare levy. This operates to effectively penalise the capital beneficiaries.

This effectively penal result is of particular concern given that these trusts are usually established not for taxation purposes, but rather for the purpose of family provision.

5. The above tax results are due to the following:

   a. The CGT provisions bring capital gains into income account for taxation purposes. Because of the division between income and capital beneficiaries in Capital Protected Trusts, and the contingent and often deferred interests of the capital beneficiaries, most trustees are unable to either account for capital in this manner or distribute capital to either the income or the capital beneficiaries.

   b. The Trust Streaming provisions further appear to require that the trustee distribute not only the taxable component of a capital gain but also the discounted component of the gain in order to tax effectively stream a capital gain to a beneficiary (see the Annexure for a detailed explanation). Thus, even the use of a tax definition of net income for these trustees is inadequate to enable these trustees to make the income beneficiaries specifically entitled to such of a capital gain that would be required to ensure that it is taxed in their hands, and so as to ensure that they are able to receive the full benefit of the CGT discounts that would normally apply.

   c. If the trustee is unable to distribute the gain, pursuant to the Trust Streaming provisions, then it appears that the proportionate rule applies to tax the gain in the hands of the income beneficiaries in proportion with their income distributions. In this regard, the Trust Streaming provisions have brought greater clarity to these circumstances.

   d. It is unclear pursuant to the Trust Streaming provisions as to when the trustee of a Capital Protected Trust might be able to elect to be assessed on a capital gain (see the Annexure for a detailed explanation). If, however, a trustee were to so elect, it appears that it would be taxed at the top marginal rate plus Medicare levy, and would be denied access to any of the CGT discounts that might otherwise apply to the relevant gain.

   e. Thus the above tax results are due to a combination of the separation between income and capital beneficiaries, the manner in which the Trust Streaming provisions deem the proportionate rule to apply to capital gains to which no beneficiary is specifically entitled, and the tax rates that apply to trustees on accumulated capital gains.

6. In addition to the effectively penal manner in which Capital Protected Trusts are taxed on capital gains, there is significant uncertainty regarding the manner in which the current taxation legislation applies in each specific case.

7. The issues and tax results outlined above will apply to various degrees to any trust in which the trustee is restricted as to the distribution of capital. In this regard, we wish to draw the Government's attention to the fact that many trusts which might initially appear to be a "typical" "family discretionary trust" (i.e. a fully discretionary trust as to both income and capital), upon closer inspection, are actually restricted as to capital. Some examples of restrictions include:

    a. The requirement for the trustee to obtain the consent of the appointor, which may or may note be possible at the time (e.g. where the appointor has lost capacity);

    b. A percentage limit on the amount of capital the trustee can distribute prior to the vesting of the trust;

    c. A limit on the reasons for which the trustee can distribute capital (e.g. for the maintenance and education only);

    d. A prohibition on the trustee distributing any capital prior to the vesting of the trust.

8. We are concerned that the current regime as to the taxation of capital gains earned by trusts, and in particular the Trust Streaming provisions, are presently operating to produce results that are contrary to the Government's stated policy principles as set out in section 1.2 of the Consultation Paper. In particular, we are concerned that:

    a. Capital Protected Trusts (and indeed many apparently discretionary trusts) are not taxed on a "flow through" basis. Rather, beneficiaries are taxed on amounts to which they never receive any financial benefit;

    b. This is an anomalous taxation result;

    c. There is considerable uncertainty as to the operation of the Trust Streaming provisions as they apply to Capital Protected Trusts, particularly as to when the trustee might be permitted to elect to be assessed on a capital gain; and

    d. The Trust Streaming provisions are complex, and thus place heavier time and cost burdens upon the trustees of Capital Protected Trusts in order to ensure their compliance with the provisions.

Proposal – A Possible Solution

In light of the above reasoning, we submit that the Government ought to consider permitting all trustees to accumulate capital gains with access to the CGT discounts that would otherwise be available to an individual taxpayer.

Pursuant to such a provision, the trustee would still be taxed on the taxable component of a capital gain, resulting in the same revenue position for the Government as if the asset in question was personally owned by an individual. Indeed, assuming the

Government maintains the position that the top marginal rate plus Medicare levy applies to trustees, such a provision would still give the Government a more favourable revenue position than if the asset in question was personally owned by an individual on a lower marginal rate.

In our opinion, this change to the taxation of trustees would be relatively simple and certain. More significantly, this would produce tax results that are more in line with the Government's stated policy principle of flow through taxation in relation to Capital Protected Trusts. This is because:

1. Income beneficiaries who will never receive any financial benefit in the capital gain will not be taxed;

2. The tax payable would be paid out of trust capital, to which the capital beneficiaries, whether already determined or not, will ultimately benefit; and

3. If the trustee is granted access to the marginal rates and the CGT discounts, the capital gain itself will be taxed at the appropriate rates such that capital beneficiaries with only contingent interests will not be unduly penalised.

Proposed Reform Models

We have considered the various options for reform laid out in the Consultation Paper. Whilst we make no particular comment as to our preferred model, we wish to particularly draw the Government's attention to the Patch Model and the TAD Model as they apply to Capital Protected Trusts.

The Patch Model

The Patch Model (section 8.1 of the Consultation Paper) involves defining the term "income of the trust estate" to be aligned with a tax definition of net income. That is, net capital gains would be included within the definition of the net income of a trust.

Whilst this approach would work well with fully discretionary trusts, it is unclear how this would impact upon Capital Protected Trusts. Because a key objective of Capital Protected Trusts is to preserve the capital for the capital beneficiaries, their terms often require an accounting definition of net income (i.e. to deliberately ensure that capital gains accrue for the benefit of the capital beneficiaries).

Further, trustees are often prohibited from or are unable to distribute capital to the capital beneficiaries prior to the ending of the trust.

Thus the trustees of Capital Protected Trusts are often forced to either deliberately accumulate capital gains and elect to be taxed on them, or treat the gains as gains to which no beneficiary is presently entitled, and thus leave the income beneficiaries to be taxed on the gain in proportion to their income distribution (see our submission above).

It appears to us that the mere re-definition of "income of the trust estate" would not cure this issue. Rather, there would need to be further express provision made to address

the situation where trustees are prohibited from distributing capital or are prohibited from adopting a tax definition of net income. To that end, we refer you to proposed solution of permitting trustees to accumulate capital gains at marginal rates with full access to the CGT discounts.

The TAD Model

If the TAD Model is pursued with no further modification, Capital Protected Trusts could effectively become a permanently penalised class of trusts.

Because the TAD Model effectively codifies a quantum approach, and because these trusts can almost never distribute capital gains prior to vesting (save for express provision in their instruments), they will almost always be forced into an accumulation position. Thus, on current rates, the trustee would be taxed on net capital gains at the top marginal rate plus Medicare Levy, and the question remains as to whether or not the trustee would have access to the CGT discounts that would otherwise apply.

We therefore submit that if the TAD Model is pursued, that there be modifications along the lines of:

1. A reconsideration of the tax rate that applies to trustees; or

2. A reconsideration of trustees' access to the CGT discounts that apply to individuals; or

3. A reconsideration of the requirements for making beneficiaries specifically entitled to net capital gains; or

4. A deliberate carve-out for Capital Protected Trusts.

In this regard, if our proposal to change the way in which trustee accumulations of capital gains are taxed were to be accepted, this concern with the TAD Model would be addressed.

Urgent Request for Clarification

Finally, regardless of which approach the Government elects in the broader reform of the taxation of trusts, we urgently request that the Government provide clarification on the application of the Streaming Provisions as they apply to net capital gains made by Capital Protected Trusts with respect to:

1. The circumstances in which the trustee of a Capital Protected Trust can properly elect to be assessed on a capital gain, particularly if there is no beneficiary with a vested entitlement to the capital (see Scenarios 1 and 2 in the Annexure);

2. Whether or not the proportionate rule would automatically apply to capital gains made in life interests (see Scenario 1 in the Annexure);

3. Whether or not there are other circumstances in or means by which the trustees of Capital Protected Trusts can ensure that their beneficiaries obtain the benefit of the CGT discounts.

Conclusion

Please refer to the enclosed Annexure for the details of our reasoning.

We appreciate the opportunity to make this submission. Please feel free to direct any queries you may have to the writers.

Yours faithfully
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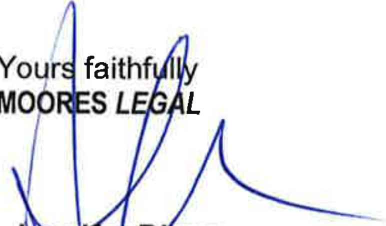

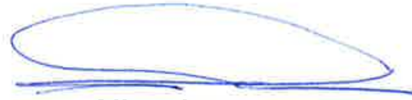

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Enclosure

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Annexure

The following are the detailed reasons behind our submission:

Types of Capital Protected Trusts

The following are more extensive definitions of the trusts that we have collectively termed "Capital Protected Trusts":

1. **Excepted Proceeds Trusts** are trusts established by deed that comply with section 102AG(2) of the *Income Tax Assessment Act 1936* ("ITAA 1936"). The key requirements for the establishment of these trusts are that:

    a. They are funded by proceeds arising out of the death of a child's parent, the injury to a child, or a breakdown in a child's family; and

    b. The terms of the trust provide that the child acquires the trust property (i.e. trust capital) when the trust ends (section 102AGA(2A) of the *ITAA 1936*).

    Further, whilst the child is also an income beneficiary, there are often other income beneficiaries as well, e.g. the child's surviving parent and siblings. In such circumstances, the child's rights to the capital of the trust are subjected to the prior rights of the income beneficiaries. In other words, the interest of the capital beneficiaries are vested but deferred. Thus, even upon the child attaining majority age, the child is unable to call for the capital of the trust until such time as the rights of the income beneficiaries have been satisfied (i.e. upon the death of the income beneficiaries, upon the income beneficiaries consenting to a distribution of capital, or upon the vesting date of the trust.)

2. **Life interests** are established by deed or Will typically for the purpose of preserving an inheritance for a Willmaker's children, but at the same time to ensure proper provision for the Willmaker's spouse. Often the spouse is a second spouse who is not the parent of the Willmaker's surviving children. Alternatively, there is a concern to ensure that a child who is under some sort of vulnerability (e.g. mental illness or disability, addiction, or spendthrift tendencies) and their children receives the proper benefit to their inheritance. The terms of life interests commonly provide that:

    a. The capital of the trust is to be held on trust for remainder beneficiaries who cannot take the capital until after the death of the life tenant. In the case of life interests established pursuant to a Will, the class of remainder beneficiaries often cannot be determined until the time of the death of the life

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tenant, and so any interest that remainder beneficiaries might have in the capital of the trust are only contingent;

b. During the lifetime of the life tenant, the income of the trust is distributed to the life tenant, and, in some cases, certain limited amounts of capital may also be distributed to the life tenant at the exercise of the trustee's discretion; and

c. In some cases, particularly where the life tenant is the child of the Willmaker rather than the surviving spouse, there may be other beneficiaries included as to income, e.g. the children and dependants of the life tenant, with the trustee having a discretion to distribute income amongst them.

3. **Apparently discretionary trusts with restrictions on capital distribution** – It is not uncommon to find in deeds establishing so called "family trusts" restrictions upon the trustee's power to distribute capital. This is particularly the case with older trust deeds. Examples of such restrictions that we have encountered in practice include:

    a. The requirement for the trustee to obtain the consent of the appointor, which may or may note be possible at the time (e.g. where the appointor has lost capacity);

    b. A percentage limit on the amount of capital the trustee can distribute prior to the vesting of the trust;

    c. A limit on the reasons for which the trustee can distribute capital (e.g. for the maintenance and education only);

    d. A prohibition on the trustee distributing any capital prior to the vesting of the trust.

    Whilst the rationale behind the terms of these trusts are often less express, the presence of such restrictions makes it is apparent that the settlor had at least some concern as to the preservation of trust capital.

The key point of commonality for these trusts, in addition to the separation between income and capital beneficiaries, is that their primary purpose is **family provision**, most usually to provide for minor beneficiaries who have suffered a loss that falls within one of the scenarios outlined in section 102AG of the ITAA 1936, or for the spouses and children of a Willmaker in complex estate planning scenarios.

From a trust accounting perspective, because a key objective of these trusts is capital protection, their instruments usually require the trustee to determine the net income of the trust by reference to trust, rather than taxation concepts. This is particularly the case with Excepted Proceeds Trusts and life interests established for spouses. In some instances such as life interests established for a vulnerable child, where the primary concern is the proper expenditure of the child's inheritance during the child's lifetime, the

trust instrument may permit the trustee to use define net income in accordance with taxation concepts.

Operation of the Trust Streaming Provisions in relation to Capital Gains

Our reasoning behind our submission is based upon the following understanding of the Trust Streaming provisions as they apply to capital gains.

If the trustee of a trust wishes to pass the benefits of a net capital gain to a particular beneficiary such that the beneficiary is taxed on the gain and can receive the benefit of the CGT discounts that would normally apply, the Trust Streaming provisions require the trustee to distribute not just the taxable components of the gain, but also the discounted components.

Section 115-228 of the *Income Tax Assessment Act 1997* ("ITAA1997") requires the trustee to apply the formula:

$$\text{Capital Gain} \times \frac{\text{Share of net financial benefit}}{\text{Net financial benefit}}$$

in order to determine the amount to which a beneficiary is specifically entitled. From the worked examples provided by the ATO and the Explanatory Memorandum (EM) to the Trust Streaming provisions (see for example, ATO Guide to capital gains tax 2010 – 11 Example 16, and EM Examples 2.8 – 2.10)), it is apparent that:

- the "Capital Gain" means the total gain *prior* to offset by any capital losses;
- the "Net financial benefit" means the capital gain *after* losses have been have been accounted for but *before* any discounts have been applied; and
- the "Share of net financial benefit" is the beneficiary's percentage share of the Net financial benefit.

Thus the amount of a capital gain to which a beneficiary is specifically entitled is always calculated by reference to the capital gain *prior* to its reduction by any applicable discounts. (Step 1 of the method statement pursuant to sections 115-215(3), 115-225 and 115-227)

This amount is then converted into a fraction (section 115-115(1)(b)), and this fraction is then multiplied against the trust's taxable income that relates to the gain, which comprises the net capital gain *after* the discounts have been applied (section 115-225(1)).

It is apparent from a consideration of the provisions and the worked examples, that in order to ensure that the full tax liability relating to a capital gain is borne by the beneficiaries who actually receive the benefit in the gain, the trustee must have the power to distribute both the taxable and the discounted components of the gain to those beneficiaries. i.e. The trustee must be able to distribute both the amount of the gain that

comprises a part of the trust's taxable income, *and* the part of the gain that remains as part of the trust's capital for both trust accounting and tax purposes. This is necessary in order to ensure that beneficiaries are specifically entitled to 100% of the net financial benefit of the capital gain pursuant to Step 1.

Thus, as we understand it, the trustee must have the power to distribute the discounted component of the gain to a beneficiary either expressly as a power to distribute capital of the fund, or have a deed that defines income to include the discounted component. This would seem to be the case irrespective of whether the definition of income in the deed is an accounting definition or income is defined in accordance with subsection 95(1) of the ITAA 1936.

Where a trustee is unable to distribute the discounted component of a capital gain, such as in the case of a Capital Protected Trust, even if income is defined in accordance with subsection 95(1) of the ITAA 1936, the trustee will be unable to make beneficiaries specifically entitled to 100% of the net financial benefit of a capital gain. Thus, there will *always* be a percentage of the capital gain to which no beneficiary is specifically entitled. This must then be assessed in the hands of the beneficiaries who have received an income distribution in that year, in proportion to their respective income distribution. In the case of a Capital Protected Trust, this results in the income beneficiaries bearing the tax on amounts they can never receive.

Specific Applications of the Trust Streaming Provisions

Under the present taxation regime, there is significant uncertainty as to the manner in which capital gains incurred by Capital Protected Trusts are taxed, and we request that these anomalies be taken into account and clarified when the Government implements its reform.

Scenario 1 – The most common scenario

When the trustee of a Capital Protected Trust incurs a taxable capital gain (whether notionally or as a result of realising the gain on asset), by application of trust concepts of income, this gain must be held on capital account, even whilst the CGT provisions treat these gains as taxable income, subject to the various discounts. Further, because the trustee's ability to distribute capital before the vesting of such trusts is significantly restricted, and the capital beneficiaries do not have a vested interest in the majority of Capital Protected Trusts, the trustee cannot make a capital beneficiary of the trust either presently entitled or specifically entitled to these gains.

Because the trustee can never make a beneficiary specifically entitled to any portion of a capital gain, pursuant to the Trust Streaming provisions, it appears that the proportionate rule must always apply to tax capital gains in the hands of the income beneficiaries, none of whom will have received any financial benefit in the gain.

This result is particularly marked in the Life Interests, where the life tenant is never a beneficiary to the trust capital. In the case of the Excepted Proceeds Trusts, at least the

child in question is both an income and a capital beneficiary, and so the child can expect to eventually receive a real benefit from the capital gain, albeit, only when the trust ends.

In these circumstances, we request clarity as to whether this is indeed the case. Further, we request clarity as to whether these income beneficiaries would at least be able to receive the benefit of the discounts that would otherwise apply pursuant to Divisions 115, 118, 126, 128, or 152 of the ITAA 1997.

Scenario 2 – Trustee election to be assessed

In the case of the Excepted Proceeds Trusts, where the capital beneficiary has a vested by deferred interest in the capital, it appears that net capital gains could fall within the scope of Example 2.13 in the Explanatory Memorandum to the Trust Streaming provisions, whereby the trustee can elect to be taxed on the gain. This, however, would mean that tax is paid on the gain at the top marginal rate plus Medicare levy, and it appears that the trustee is denied the benefit of the CGT discounts that might otherwise be available to a taxpayer.

We request clarity as to whether or not the trustee would be able to make an election in this case, and confirmation as to the manner in which the trustee would be taxed on the gain.

In the case of life interests, for the most part, the class of capital beneficiaries remains contingent until such time as the life tenant dies. Often, the persons who fall within class of capital beneficiaries cannot even be identified until after the death of the life tenant.

In these cases, it is unclear whether the trustee would be able to make an election to be taxed on a capital gain along the lines of Example 2.13, or whether it is forced to always apply the proportionate rule. In the first case, the top marginal rate plus Medicare levy would apply, and in the second case, the problem of income beneficiaries being taxed on amounts they will never benefit from remains. In either case, it is unclear whether either the trustee or the income beneficiaries would be able to receive the benefit of any of the CGT discounts that might otherwise apply.

We request clarity as to whether or not the trustee would be able to make an election to be assessed in such circumstances, and further, whether or not either the trustee or the beneficiaries would be able to benefit from any CGT discounts that might otherwise apply.

Scenario 3 – Life interests with tax definition of net income

In some instances, a Willmaker or the Settlor of a trust grants broader discretion to the trustee and either deliberately requires or permits the trustee to use a tax definition of net income. This is often where the life tenant is incapable of handling money (e.g. due to mental illness or addiction or other vulnerability), and the primary concern is the proper expenditure of the child's inheritance during the child's lifetime. Such trusts often also include the life tenant's dependants and family members as lifetime beneficiaries.

Trusts that appear to be discretionary but contain restrictions as to the distribution of capital could also fall within this scenario.

In these instances, as noted above, it appears that the Trust Streaming rules require an express power to distribute trust capital as well as net income defined to include net capital gains to the lifetime beneficiaries in order to make the lifetime beneficiaries specifically entitled to the whole gain. If there is no such power, it appears that the net capital gains cannot be streamed so as to ensure that 100% of the taxable gains are taxed in the hands of beneficiaries with the benefit of any CGT discounts that might otherwise apply.

We request clarity as to whether or not this is indeed the case.

In all cases, if there is no specific provision in the trust instrument regarding who should bear these tax liabilities, then this becomes an issue that potentially generates heated disputes.