THE LAW SOCIETY OF NEW SOUTH WALES
youngLAWYERS

10 February 2012

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

By email: trust_rewrite@treasury.gov.au

Dear Sir / Madam,

Response to the consultation paper titled "Modernising the taxation of trust income – options for reform"

Thank you for your invitation to provide feedback and comments in respect of the consultation paper titled "*Modernising the taxation of trust income – options for reform*".

The NSW Young Lawyers Taxation Law Committee and Business Law Committee are pleased to provide the ***enclosed*** joint response for your consideration. To provide a meaningful submission, we have responded to the focus questions that we had specific points to raise.

NSW Young Lawyers is a division of the Law Society of New South Wales. Membership of the NSW Young Lawyers is free and automatic for all NSW lawyers under 36 years and/or in their first five years of practice, and law students. Membership of its committees is voluntary.

If you would like to discuss any of our comments, or have any questions, please contact Adam Ahmed (tax.chair@younglawyers.com.au or (02) 9455 9593) or Grace Ho (taxlaw.vicechair@younglawyers.com.au / (02) 8922 5262).

Yours faithfully

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Taxation Law & Business Law Committees

Response to Treasury in respect of Consultation Paper titled "*Modernising the taxation of trust income – options for reform*"

Date **Friday, 10 February 2012**

Joint Submission prepared by the Taxation Law Committee and the Business Law Committee

The General Manager
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Our Response

We refer to the Consultation Paper titled "*Modernising the taxation of trust income – options for reform*" issued by Treasury in November 2011 (***Consultation Paper***).

We have considered the questions set out on pages 43 and 44 of the Consultation Paper under the heading "Questions for Consultation" and set out our responses below for your consideration.

Capitalised terms used in this submission are defined as set out in Annexure A

Question 1

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

Response:

We do not believe that the policy principles outlined in Chapter 1 of the Consultation Paper accurately reflect the existing framework for the taxation of trust income.

Set out below are some of the issues we have identified:

a) Tax liabilities in respect of the income and capital gains of a trust should 'follow the money' in that they should attach to the entities that receive the economic benefits from the trust.

The following discusses a number of circumstances under the existing framework where tax liabilities do not 'follow the money'.

As highlighted on page 14 of the Consultation Paper, under the existing framework a beneficiary may be taxed on more than they are entitled to receive where taxable income exceeds a trust's distributable income. Whilst the example on page 14 of the Consultation Paper outlines a situation where tax is manipulated via the trustee using an income reclassification power, there are many other situations where taxable income can exceed a trust's distributable income without there being any anti-avoidance issue. For example, a trust may have incurred prior year losses that it cannot deduct under the tax law because it does not satisfy the trust loss provisions, but still recoups those losses against the trust's distributable income.

Another example where the tax liability does not follow the money is where a capital beneficiary holds an interest in a trust capital gain but does not have a right to demand payment of the capital gain (e.g. a remainderman of a life interest).

The recently enacted trust streaming provisions that utilise the concept of "specific entitlement" has partly resolved this problem. Prior to the trust streaming provisions being enacted, such capital gain would have been taxed to the trustee at the top marginal tax rate under section 99A of the ITAA36.

The concept of a specific entitlement allows the capital beneficiary to pay tax on the gain at their individual marginal tax rate. However, there is still a problem in that the capital beneficiary may not, under the terms of the trust, be entitled to actually receive a distribution of capital gain in the relevant income year – it still remains in the trust. In such a situation the capital beneficiary may have cash flow issues in funding any tax payable. Section 115-230 of the ITAA97 was amended to allow the trustee to pay tax on this capital gain, but the taxation is at the top marginal tax rate under section 99A of the ITAA36. This is unfair given that the accumulation of the capital gain within the trust is an inherent feature of the trust which neither the capital beneficiary nor the trustee can alter.

Under the recently enacted trust streaming provisions, where beneficiaries are not made specifically entitled to 100% of a capital gain or franked dividend derived by the trust, a situation may arise where a beneficiary may be subject to tax on a greater capital gain or franked dividend than they are actually entitled to receive from the trust. This is because the trust streaming provisions spread the unallocated portion of any franked dividend or capital gain across presently entitled beneficiaries on a proportionate basis. In our view this is unfair.

b) 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.

The fact that trust taxation may not always "follow the money" shows that this principle is not reflected in the existing framework for the taxation of trusts.

Much of the discussion in the Consultation Paper and previous Discussion Paper released by Treasury[1] is focused on concerns about tax manipulation. It is suggested that an even-handed approach should be taken in drafting any tax rewrite given that anomalous taxation under the existing framework for the taxation of trusts may arise in situations where there is no tax avoidance activity.

It is also suggested that Treasury have regard to various anti-avoidance provisions, which are already in the tax law, before drafting new trust focused anti-avoidance provisions as part of the new rewrite. Those anti-avoidance provisions include the trust stripping provisions in section 100A of the ITAA36, the failure to notify an exempt entity of a present entitlement to trust income provisions in section 100AA of the ITAA36, the provisions in section 100AB of the ITAA 36 which adjust an exempt entity's Division 6 percentage to a benchmark, the provisions of the *Trust Recoupment Tax Assessment Act 1985* (Cth) and Part IVA of the ITAA36.

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

Due to its complexity, the existing framework does not achieve this aim. Many trustees incur compliance costs in seeking taxation advice on matters that should be relatively simple, for example how a trustee should draft their distribution resolution.

An example of the complexity of the current trust taxation regime is that where a trust derives a capital gain or franked dividend and the trustee distributes trust income to multiple beneficiaries, currently it can take seven to eight (non-intuitive) steps to work out a beneficiary's tax on a trust distribution under the trust streaming provisions.

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[1] **"*Improving the Taxation of Trust Income*" Discussion Paper issued by Treasury in March 2011.**

A further example of complexity is the trust loss provisions. These provisions are complex (particularly where discretionary trusts and chains of trusts are involved) and difficult to satisfy. The pattern of distributions test conflicts with the discretionary nature of a discretionary trust, so these trusts generally need to make a family trust election in order to recoup their prior year tax losses, which then limits the beneficiaries who can receive distributions from the trust.

There are numerous other uncertainties in the existing framework. These include, but are not limited to:

- the uncertainties concerning trust streaming;
- whether bare trusts are looked through for the purposes of the income tax law;
- what is a 'fixed trust' for the purposes of the trust loss and franking provisions; and
- whether the Commissioner of Taxation is correct in his sub-trust analysis with regards to the application of Division 7A of Part III of the ITAA36 to corporate beneficiaries in Taxation Ruling TR 2010/3.

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

Prior to the ATO's decision statement in relation to *FCT v Bamford [2010] HCA 10* (***Bamford***) it had been a reasonably clear industry practice that streaming was possible. The previous example in subsection 207-35(3) of the ITAA97 (as it existed prior to its repeal when the trust streaming provisions were enacted) suggested that the tax law contemplated that streaming was possible. The withholding tax provisions and the exempt income provisions in Division 6 also support this practice, as these provisions do not operate properly without it being possible to stream income.

Given the ATO's view that income streaming is not possible because of Bamford (a view which we note is debatable), the existing framework does not provide clarity in relation to this principle.

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

The current framework is guided by this principle. Currently there is not a level playing field for trusts and companies with respect to losses. The complex trust loss provisions mean that a trust is more likely to lose the benefit of being able to recoup its prior year tax losses than a company.

Question 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?

Response:

We agree that the areas identified by the Government as high priority on page 3 of the Consultation Paper are in need of reform and are suitably prioritised.

In our submission the following areas should also be given a high priority:

a) The fixed trust issue for both trust loss and franking purposes

We understand that the Government proposes to examine this issue through a separate process. However, we submit that this separate process should have equal priority with the trust rewrite process. This is because the issue of whether a trust is a fixed trust affects the trust's ability to carry forward losses and to pass the benefit of franking credits to beneficiaries.

The case of *Colonial First State Investments v FCT* [2011] FCA 16 (***Colonial***) is problematic in this context because it suggests that if a trust has a variation power then it cannot be a fixed trust. This decision effectively means that most modern trusts cannot be classed as fixed trusts since most would have a variation power.

This is extremely problematic for unit trusts which are held by unrelated business partners. If such trusts are not classed as fixed trusts then they cannot pass on the benefit of franking credits attached to any dividends they receive. The standard solution for non-fixed trusts (such as discretionary trusts) to be able to pass on the benefit of franking credits to beneficiaries is for the non-fixed trust to make a family trust election. A unit trust which is held by unrelated business partners cannot adopt this solution.

This is because it is impractical for such a unit trust to make a family trust election since such an election would have the practical effect of locking out one of the unrelated business partners from being able to benefit from the trust. This is because once a trust has made a family trust election the trust can only practically make income and capital distributions to persons and entities which fall within a statutorily defined family group. Distributions outside the family group named in the election are subject to family trust distributions tax. Accordingly distributions can be made to one of the business partners whose family group is covered by the election but not to the other business partner or their related entities because otherwise family trust distributions tax would be triggered.

As noted on pages 24 and 25 of the Consultation Paper, the Government has already announced changes to the law to give some certainty to MITs on this fixed trust issue and has accepted that a general review of the fixed trust rules be undertaken for other unit trusts in general. We submit that this review for other unit trusts be prioritised as other unit trusts encounter the same issues as MITs. To not prioritise this issue would create inequality among small to medium sized enterprises and larger corporations who adopt and use MITs.

b) The meaning of 'absolute entitlement' for Capital Gains Tax purposes

The issue of what constitutes an absolute entitlement for the purposes of section 106-50 of the ITAA97 should be clarified. The ATO tried to clarify the concept in draft ruling TR 2004/D25, however the draft ruling has never been finalised with the result that taxpayers are still uncertain as to when this concept applies.

Given that the taxation of trust income rewrite will clarify the scope of Division 6 (i.e. when it will or will not apply to a type of trust) and will examine whether custodian-like trusts should be looked through[2], it may be beneficial for the Government to consider whether the absolute entitlement issue should be clarified or alternatively whether this concept can be superseded by a general look through approach that can be applied to all bare trust-like structures.[3]

Examining this issue would assist also with capital gains tax issues raised by instalment warrants and limited recourse borrowing arrangements undertaken by superannuation funds. Where these arrangements are undertaken, there is an issue as to whether a capital gains tax liability is triggered when the asset forming the corpus of the instalment warrant trust is transferred to the beneficiary. Most instalment warrant trusts are drafted with the intent that the beneficiary is absolutely entitled so that no capital gains tax liability is triggered. However, because the concept of absolute entitlement is not settled and because of certain provisions in the instalment warrant trust deed which mean that it is not a pure bare trust, there has been uncertainty as to whether the goal of preventing a capital gains tax liability being triggered is achieved.

In the 2011/2012 Budget, the Government reconfirmed that it would legislate to provide look through income tax treatment for instalment warrants over direct and indirect interests in listed securities in widely held entities to deal with the capital gains tax issue for these type of instalment warrants[4]. However, instalment warrant trusts are established over many other types of assets – notably real property. If this issue of absolute entitlement is given priority in the trust rewrite then it would assist many self managed superannuation funds which have taken advantage of the superannuation borrowing rules to borrow to invest using instalment warrant trusts.

c) Extending the deadline for making trust distributions

As discussed on pages 15 and 33 of the Consultation Paper, the current requirement that trustees need to make their trustee resolutions by 30 June so as to avoid trustee taxation under section 99A of the ITAA36 (with the exception of a specific entitlement to capital where the trustee has up to 31 August) is difficult to achieve practically. This is because most trust accounts are not completed until well after 30 June.

We suggest that the deadline for making trust resolutions be extended as a priority. MITs are allowed 3 months to distribute their income to beneficiaries before the trustee of the MIT is taxed. We suggest a similar extension be provided to trusts generally.

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[2] Refer to pages 9 and 10 of the Consultation Paper.
[3] This 'look-through' approach was suggested on page 32 of the Consultation Paper.
[4] 'Look through treatment for instalment warrants and similar arrangements' in Budget Paper No.2, Part 1: Revenue Measures, Treasury - http://www.budget.gov.au/2011-12/content/bp2/html/bp2_revenue-07.htm

Question 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?

Response:

We submit that a single process of updating and rewriting the trust income tax provisions would be preferred for the following reasons:

a) **Greater certainty**, because:

- there is no interim period after the early stage(s) are drafted, or in force, but the later stages are yet to be drafted or come into force;
- there is a reduced chance of the reform not being carried through to its completion, for example, because there is a change in the federal government; and
- if all changes are made at the same time and there is no possibility for the changes being made in a piece-meal manner with major components being left missing.

b) **Reduced compliance costs** - a staged approach would be likely to increase compliance costs for trustees, as advice would need to be obtained at different stages of the reform; and

c) **Increased consistency in drafting of legislation and terminology** used as a result of the same drafters drafting the one legislation.

Despite the above, we submit that it would be advantageous to stage the commencement date and the implementation of the finalised legislation over a period of time through transitional provisions in legislation to allow trusts time to transition to new trusts taxation framework and to make any amendments that may be required to their trust deeds.

Question 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?

Response:

Uncertainty in respect of the scope of Division 6 is one of the key issues hampering effective taxation of trust income.

While some merit lies in the clarification of the scope of Division 6 using either a general principle or a comprehensive list, our view is that adoption of a comprehensive list would be preferable, as it will better serve the task of diffusing this uncertainty.

The use of a comprehensive list will provide a greater level of certainty, clarity and precision for taxpayers, whilst potentially limiting or reducing compliance costs for trustees and administrative costs for the ATO.

Although from time to time legislative amendments may be required to update such a comprehensive list, this would be preferable to attempting to define a suitably robust general principle to cover all trusts potentially (considering the extensive differences in the nature of particular trust structures). The comprehensive list could be outlined in regulations, allowing it to be more easily updated from time to time as and when new trust situations are encountered.

Where a general principle approach is adopted, this could necessitate the provision of an extensive ATO ruling outlining the circumstances in which the generality will be curtailed. As a result, this is likely to result in increased administrative costs for the ATO and less certainty for taxpayers. Further, such an approach would likely lead to a greater number of private ruling applications (and potentially litigation) than the comprehensive list approach, and consequently be a greater administrative burden and more red tape.

The general principle approach, however, is not entirely unmeritorious. We recognise that a general principle approach reflects the legislatures currently favoured approach of principles based drafting, however we do not consider such an approach suitable to an area where the specifics of particular trusts necessitate different treatment.

Regardless of which drafting method is ultimately adopted, the trust should remain a 'look-through' entity with beneficiaries being directly assessed.

Response to Question 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?

Response:

In order to clarify the scope of Division 6, and as a matter of statutory construction, it would be appropriate for Division 6 to operate as a 'catch-all' division in the event that other specific trust regimes do not apply.

The types of trusts that should not fall within the scope of Division 6 (subject to any interaction between the specific trust regime and Division 6) include:

1. Superannuation funds;
2. Managed Investment Trusts;
3. Nominee and custodian type trusts;
4. Investor Directed Portfolio Services;
5. Instalment Warrant trusts; and
6. Bare trusts.

Division 6 should not apply to trusts which are otherwise governed by a specific taxation regime (superannuation funds and MITs) or to bare trust-like structures where income and capital rights are completely fixed and all such income and capital flows directly to the beneficiary (being the latter four trusts mentioned above).

Division 6 should also not apply to bare trust-like structures in order to reduce compliance costs. If bare trust-like structures were carved out of Division 6 and the income tax law operated to look-through the bare trust and to impose all tax obligations on the beneficiary, then overall compliance costs would be reduced since the trustee of the bare trust would not need to lodge a trust tax return. It makes little sense for the trustee to incur this cost each year when the tax will always ultimately be borne by the beneficiary of the bare trust.

If this look-through approach was extended and adopted as a general principle for the purposes of the whole income tax regime, then it may help to finally resolve the outstanding capital gains tax issues relating to what 'absolute entitlement' means for the purposes of section 106-50 of the ITAA 1997 and whether capital gains tax is triggered on the transfer of an asset which is subject to an instalment warrant arrangement from the bare trustee to the beneficiary under the arrangement.

In the 2011/2012 Budget the Government reconfirmed that it would legislate to provide look-through income tax treatment for instalment warrants over direct and indirect interests in listed securities in widely held entities. However, a major deficiency in this proposal is that it will not cover instalment warrants over real property.

It is difficult to understand why the proposed look-through treatment is confined to just the nominated asset classes. Self managed superannuation funds that borrow under an instalment warrant arrangement (as required by the superannuation law) commonly use the borrowed funds to invest in real property. If a look-through approach is adopted as a general principle under the income tax regime, we submit that it may resolve the uncertainties concerning the capital gains tax treatment of superannuation funds borrowing under instalment warrant arrangements in respect of all asset classes.

Another benefit of adopting a general look-through approach is that it would obviate the need to draft specific look through provisions in different parts of the income tax legislation. One general look through rule could apply for the purposes of the whole income tax regime. This would help to reduce the size of the income tax legislation.

Question 6

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

Response:

We have chosen not to comment on this question.

Question 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?

Response:

The practice of making adjustments to reconcile the differences in accounting definitions and taxation law definitions (tax-effect accounting) is an unfortunate consequence of the divergence in each discipline's philosophy.

Trust law and taxation law are affected in the same manner. Trust law has been developed from concepts of property and taxation law has been developed through public utility. Moving away from trust law concepts to tax law concepts may create more certainty in the application of taxation law and can lead to less reliance on specific clauses of trust deeds to determine the taxable income of trustees and beneficiaries.

We agree with Treasury's suggestion that distributable income using tax concepts needs to be adjusted for notional amounts[5]. Generally this would involve excluding such notional amounts from distributable income using tax concepts.

Such notional amounts will include:

(a) the franking credit gross up;

(b) the implicit gross up one must make to foreign income before a foreign income tax offset;

(c) attributed income such as CFC income;

(d) deemed Division 7A income that is not reflected in a trust receipt – e.g. a debt forgiveness.

We also agree with Treasury's suggestion that adjustments must be made for the capital gains tax discount. On page 10 of the Discussion Paper, Treasury expressed a wish to include the whole of the gross capital gain in distributable income using tax concepts to prevent any notion of splitting the discount from the capital gain. The way that the recently enacted trust streaming provisions operate prevents such a split and so this should no longer be a concern.

However, whether the gross capital gain is included or only the net capital gain after the discount, we recommend that the provisions introduced to effect the new trust rewrite should operate in a flexible manner to allow most trusts to allocate the capital gain to a beneficiary, whether this be via income or capital distribution powers so that section 99A of the ITAA36 does not apply. The broad flexibility provided by the concept of specific entitlement to a capital gain could be used as a template.

[5] See page 10 of the Discussion Paper.

Question 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?

Response:

Character flow-through and streaming should be provided on a general basis with specific limitations where necessary.

This approach is beneficial for the following reasons:

- general streaming is more easily understood by industry since it conforms with the industry practice which prevailed prior to the Commissioner's release of his Decision Impact Statement on *Bamford*[6];
- it conforms with the current principles-based drafting approach and would have a better ability to cover different streaming situations into the future. If specific streaming provisions were used then each time a new kind of income arises, new streaming provisions would need to be enacted. The income tax law is already voluminous and care should be taken in drafting any amendments so to be as concise as possible and not to create a situation where even more legislation is required to clarify the new amendments. It takes time to enact legislation and so taking a specific provisions approach is likely to entail uncertainty or tax unfairness in the interim before such specific provisions are enacted. This contrasts with a general streaming approach which can easily accommodate new streaming situations without the need for legislative amendments;
- many provisions in income tax law already implicitly assume that streaming is possible – for instance in *Greenhatch v FCT [2011] AATA 479* the Administrative Appeals Tribunal noted that the withholding tax provisions were based on the assumption that streaming is possible. Accordingly adopting a general streaming approach would avoid having to rewrite such provisions;
- the need for trust deed amendments is less likely under a general streaming approach than the specific provision approach. This is because most income streaming provisions in trust deeds are drafted on the basis that general streaming is possible. This appeals to the objectives of minimising compliance costs and reducing complexity.

In the event that streaming is provided using specific provisions, these provisions should cover streaming of royalties, interest income, dividends, exempt income and non-assessable non-exempt income.

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[6] For link to ***Bamford Decision Impact Statement*** - http://law.ato.gov.au/atolaw/view.htm?docid=LIT/ICD/S310/2009/00001

Question 9

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

Response:

To avoid unnecessary compliance costs related to segregating losses into classes we recommend the current way that losses are dealt with under the tax law remain. That is, trustees should have the choice to apply revenue losses against any type of revenue income and additionally revenue losses may be applied against either revenue income or capital income.

If losses were to be segregated into classes in the same way as trust income and a taxpayer was only allowed to deduct a loss against its particular class of income, then extra compliance costs would be created. These compliance costs arise not only on an annual basis but also where ownership of the trust is sold. This is because purchasers will have to conduct extra due diligence to determine the accuracy of such loss quarantining. The modern trend is to move away from such loss quarantining – for instance the quarantining of foreign losses was abolished in 2007.

There may be difficulties in allocating a loss to particular classes of income since the loss may relate to more than one class of income. An apportionment rule would need to be enacted and such a rule may not always operate fairly.

Question 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?

Response:

We have chosen not to comment on this question.

Question 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?

Response:

We have identified two areas that should be addressed at this time to allow for the effective operation of the updated new Division 6:

- **Division 6 and the Capital Gains Tax provisions**: There should be clarification of what the term 'distributions of income' and 'distributions of capital' mean for the purposes of item 3 of the table in subsection 152-70(1) of the ITAA97 (being the definition of what constitutes a small business participation percentage in a discretionary trust for the purposes of the small business CGT concessions in Division 152 of the ITAA97). There is currently uncertainty as to whether this relates to distributions of trust income or whether this relates to distributions of taxable trust income.
- **Division 6 and Division 7A**: Within Treasury's consideration of the scope of Division 6 and whether a look-through approach will be applied to bare trust-like structures, it is recommended that Treasury examine the ATO's current position on sub-trusts, corporate beneficiaries and Division 7A as outlined in Taxation Ruling TR 2010/3 to see if any legislative amendments are required.

Question 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?

Response:

Which regime?

Whilst a generic regime is desirable for the sake of simplicity, as stated in Chapter 6.2 of the Consultation Paper, it is unlikely that such a regime could produce the desired tax outcomes for all types of trusts in all cases. The inability of the current generic regime to deal with all scenarios is one of the reasons that Division 6 is currently being redrafted.

It is submitted that it is preferable that multiple targeted regimes be adopted in order to allow for more appropriate tax outcomes that are particular to any type of trust. In our view the benefits of the appropriate treatment of each type of trust would outweigh any of the interaction issues that may arise (i.e. the 'border issues'[7]), being when and how choices could be made and the 'entry and exit rules'. However, a problem with adopting a multiple targeted regime is that the different tax treatments may incentivise migration to the most tax effective regime.

An alternative model could involve a mixture of both the generic and targeted regimes, such that the generic regime acts as a backstop where the targeted regime does not apply.

[7] referred to in Chapter 6.2 of the Consultation Paper

Which approach?

The 'proportionate within class' method is preferred because it is easier to understand when compared with the other approaches. This approach is intuitive and builds on existing concepts, which is consistent with the goal of reducing compliance costs and complexity.

The 'proportionate within class' method also does not have the problem of the trustee being more likely to be taxed at the top marginal rate as it would under the TAD model.

The determination of the classes of income under the 'proportionate within class' method should be flexible and no one method should be prescribed for all types of trusts. That is, both methods described in paragraph 8.2.1 of the Consultation Paper should be available.

This would accommodate a variety of scenarios including the discretionary nature of distributions from discretionary trusts, amendments to trust deeds, and future changes to the types of income earned by a trust. However, there would need to be legislation clarifying whether or not it is possible to switch between those methods of determining the different classes of income.

Question 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?

Response:

We understand that Treasury is concerned with defining the concept of distributable income under the 'patch model' so as to prevent the possibility of tax manipulation raised by the High Court's decision in Bamford[8].

Relevantly, the High Court ruled that the income of a trust estate (ostensibly distributable income) is determined by reference to the trust deed and trust law. We also understand that Treasury is concerned that trustees may seek to utilise income and capital reclassification powers conferred upon them by the trust deed to inappropriately manipulate tax results by defining what does and does not constitute distributable income. Examples 2 and 4 of the Discussion Paper illustrate situations where a trustee seeks to reclassify what is ostensibly income into capital so as to inappropriately minimise tax.

The 'proportionate within class' model's categorisation of income assists with the streaming of trust income rather than dealing with this tax manipulation concern (although it is recognised that if this model is adopted and legislative rules are enacted which regulate how certain expenses may be allocated to different classes of trust income, then some tax manipulation related to the allocated of expenses and losses may be prevented).

Since the first step in applying the 'proportionate within class' model involves determining the trust's distributable income in the same way as the 'patch model'[9] then it would be necessary to define the concept of distributable income in the same way as outlined in the 'patch model' so as to deal with Treasury's tax manipulation concerns.

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[8] See pages 36 and 37 of the Consultation Paper and the discussion in the Discussion Paper

[9] See page 37 of the Consultation Paper.

The need to define distributable income, however, is only really a need if Treasury's tax manipulation concerns are valid. It is submitted that the provisions of sections 100A (trust stripping provisions), 100AA, 100AB of the ITAA36 and Part IVA of the ITAA36 are robust enough to deal with these concerns without the need to define distributable income.

Adopting an approach of defining distributable income would further complicate the taxation of trust income since trusts would then need to negotiate three different concepts – i.e. net income of the trust as determined by section 95 of the ITAA36, distributable income and trust income as determined by the trust deed and trust law.

Question 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?

Response:

The trustee should be taxed on unallocated amounts at a special rate rather than the top marginal tax rate.

Ideally this special rate should be the corporate tax rate since this would provide a level playing field between companies and trust structures in relation to the accumulation of income.

Additionally, making this special rate equal to the corporate tax rate would assist small business with cash flow issues related to the Commissioner's recent change of position in relation to unpaid present entitlements owed to corporate beneficiaries in closely held situations and the imposition of Division 7A.

Question 15

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

Response:

If the TAD model is adopted, the income tax law should define the concept of a 'distribution' broadly so that trust deeds do not need to be amended to allow trustees to make the required distribution needed for a beneficiary to be taxable under the TAD model.

The concept of a distribution could be modelled on the concept of a specific entitlement that currently exists in the capital gains and franked dividend streamlining provisions.

Question 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?

Response:

With any significant changes in taxation law, sufficient time should be allowed under the transitional measures to ensure that taxpayers can organise their internal, accounting and other reporting processes in order to conform to the new measures that are to be introduced. We will be able to comment further in respect of this question once the proposed amendments to Division 6 are available for consideration.

Depending on the extent of the rewrite of Division 6, it may be necessary for a trust deed of a trust to be amended. Any time there is a variation of trust the issue of whether such a variation causes a trust resettlement needs to be considered.

Capital gains tax and stamp duty liabilities may be triggered where a resettlement occurs. Whilst the recent full Federal Court case of *FCT v Clark [2011] FCAFC 5* suggests that many trust deed amendments will not cause a resettlement, the issue is not completely settled at law.

The ATO has released a statement of principles regarding the tax implications of trust resettlements (including some guidance on whether certain events give rise to a resettlement) but we submit that it would be better to have legislative clarity on this issue, if possible[10].

It is suggested that the transitional measures contain a transitional period in which trustees may amend their trusts so that the new trust rewrite provisions apply appropriately to their trusts without the need to be concerned about the variation causing a resettlement. We recommend that there should be a specific capital gains tax exemption for such amendments during the transitional period.

Although the trust rewrite concerns Federal income tax, we suggest that there be co-ordination with the State and Territory governments to provide a stamp duty exemption for such trust deed amendments.

[10] **see also *ATO 2001 Statement of Principles – refer to link:***
http://www.ato.gov.au/businesses/content.aspx?menuid=0&doc=/content/14283.htm&page=1&H1

Annexure A Table of Abbreviated Terms

Abbreviation	Meaning
ATO	Australian Taxation Office
Bamford	*Commissioner of Taxation v Bamford; Bamford v Commissioner of Taxation* [2010] HCA 10
Colonial	*Colonial First State Investments v FCT* [2011] FCA 16
Commissioner	Commissioner of Taxation
Consultation Paper	Consultation Paper titled "*Modernising the taxation of trust income –options for reform*" issued by Treasury in November 2011
Discussion Paper	Discussion Paper titled "*Improving the Taxation of Trust Income*" issued by Treasury in March 2011
Division 6	Division 6 of the ITAA36
Division 7A	Division 7A of Part III of the ITAA36
ITAA36	*Income Tax Assessment Act 1936* (Cth)
ITAA97	*Income Tax Assessment Act 1997* (Cth)
MITs	Managed Investment Trusts
TAD	'Trustee assessment and deduction' model