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**Submission to Federal Treasury
Modernising the taxation of trust income
options for reform**

PKF welcomes the opportunity of providing a submission on the consultation paper "Modernising the taxation of trust income". The current law for taxing trusts is complex and needs to be modernised.

Summary of Submission

Our submission firstly discusses some of the common uses of trusts. This sets the scene for a discussion on the suggested treatments for fixed and discretionary trusts. Below is a summary of our comments and suggestions in the submission.

- There should be varying treatment for fixed trusts and discretionary trusts.
- The definition of "fixed trust" should include trusts that provide clearly defined entitlements.
- Fixed trusts may not need many changes and could continue with the current Division 6 rules but with provision for character retention of income and gains.
- Fixed trusts that fit the current definition (vested and indefeasible) could be given total flow-through treatment i.e. treated like partnerships.
- Discretionary trusts should be taxed in accord with either the proportionate within class model or trustee assessment and deduction (TAD) model.
- If the proportionate within class model is to be implemented, the definition of income of the trust should be as per the first option in the patch model i.e. adjusted taxable income.
- Under the proportionate within class model, the classes of income should be flexible and allow the determination of classes under the trust deed or by the trustee (if the trust deed allows)
- If the TAD model is implemented, the definition of distribution should include the crediting of the distribution to a beneficiary loan account.
- Under the TAD model the rate of tax for trustee assessment is important. While a rate equivalent to the corporate tax rate initially appears attractive it could cause complications. The integrity provisions required could mean it may be easier just to tax trusts like companies.
- The time frame for a trustee of a discretionary trust to determine which beneficiaries receive distributions from the trust should be extended until the due date of lodgement of the trust return.

If you have any questions regarding this submission please contact me by phone on 02 9240 9736 or email lance.cunningham@pkf.com.au

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**Submission to Federal Treasury
by PKF Chartered Accountants
Modernising the taxation of trust income -
options for reform**

PKF Australia Limited provides the following comments regarding the Federal Treasury's consultation paper on the Modernising the taxation of trust income - options for reform.

Why do Taxpayers use Trusts

Trusts can be very flexible and versatile structures that have been used for various purposes for more than a thousand years. In recent times their use for investment and business structures has seen the complexities of these arrangements increase. The flexibility of the trust structures has contributed to the complexity of the taxation consequences of many trusts arrangements.

Although the tax treatment of trusts can be complex, most trusts are now used by small to medium business enterprises. Unfortunately many of these taxpayers and their advisers have not, until recently, appreciated the complexity of the taxation treatment of their trust arrangements (many are probably still unaware of the complexities).

To assist in the determination of the most appropriate treatment in modernising the tax treatment of trusts we provide below our summary of some of the reasons why taxpayers use trusts.

Pooled Investments:

Some taxpayers see the pooling of their investments in a trust allows greater investment opportunities than could be obtained if each invested separately. Unit trusts are generally used for this purpose and where the unit trust is widely held, it is likely to qualify as a Managed Investment Trust (MIT). Until recently these trusts would have been considered to be "fixed trusts" for tax purposes. However, the decision in *Colonial* has confirmed almost all unit trusts can't be classified as "fixed trusts" for tax purposes. We understand the proposed treatment of MIT's will ensure that MIT's with clearly defined entitlements for unit holders will be treated as fixed trusts for tax purposes.

Asset Protection

Many trusts are used to hold assets to quarantine them from other entities in a family or corporate group that may have a higher risk profile. For example the land and buildings used in a business may be held by a trust that leases it to an associated entity that carries on the business. This has the potential of keeping the land and buildings protected from being claimed by the creditors of the business.

Many land developers use stand alone trusts as special purpose entities for each building development. This allows the construction risks to be contained within the special purpose vehicle and but also allows the profits to be distributed to the owners without tax being paid by the special purpose vehicle.

Another example is where assets are held in a trust to keep them away from being claimed by other family members or their spouses in a family dispute or marriage breakup. However, the family court may have the power to cut through this protection in some cases

Succession Planning

Discretionary Trusts can also be used to allow the effective transfer of assets from one generation to the next without having to go through a will or intestacy. This is particularly useful where control of a business or other assets is being passed on to another family member before the death of the original

controller. This allows stamp duty and CGT free transfer of control of the business or other assets with a similar tax outcome to the transfer of the assets through a deceased estate.

Flexibility of Distributions

The flexibility of income and capital distributions through a discretionary trust is probably the most common reason for the use of trusts by small to medium businesses, particularly those run by the members of a single family. This flexibility allows the trustee to distribute income and capital from the trust to the family members or entities that either most need or can make best use of the income or capital distribution. One of the most important considerations in this regard is the tax profile of the particular family member's entities.

Until the High Court's decision in the *Bamford* case many taxpayers and their advisers considered that streaming of classes of income was possible through a trust (where the trust deed allowed it). It was thought that streaming allowed trustees of discretionary trusts to allocate specific types of income or gains to specific beneficiaries, usually the beneficiaries that obtained the best tax outcome from the streaming of the specific type of income or gain.

The *Bamford* decision indicated that streaming of specific income and gains through a trust was not effective in streaming the tax attributes of the specific income of gain to specific beneficiaries, but rather the beneficiaries were assessed on a proportionate basis on the un-allocated un-dissected net income of the trust. The Government partially restored the ability to stream by introducing Division 6E, ITAA 1936, which allows the streaming of taxable capital gains and imputation credits/offsets where beneficiaries are 'specifically entitled to the relevant capital gains or franked dividends. This indicates that the Government's policy is to allow at least partial streaming of trust income and gains.

Varying Treatment for Varying Uses

We assume the Government accepts that the above uses of trusts generally result in the appropriate commercial, legal and tax outcomes for the community (subject to appropriate integrity measures to guard against inappropriate manipulation of the tax outcomes). On this basis, the Government should provide an appropriate taxing mechanism that is as simple and efficient as possible for the particular types of trusts.

There may be a need for different rules for different types of trusts. Some trusts have been or will soon be given specific tax treatment that suits the use of these trusts. Some trusts are taxed like companies (e.g. public trading trusts) and MIT's will soon be given a specific taxing regime. We suggest that a distinction also be made for the tax treatment between non-MIT fixed trusts and discretionary trusts.

Fixed Trusts (non-MIT)

The fixed entitlements provided by fixed trusts results in less flexibility for the trustees and beneficiaries than discretionary trusts. However, following the *Colonial* decision it is likely that very few trusts would qualify as 'fixed trusts' for income tax purposes.

This is a major issue and we suggest that the proposed clarification of 'fixed trust' treatment for MIT be extended to other trusts that provide clearly defined entitlements to unitholders/beneficiaries.

The fixed entitlements provided by fixed trusts generally mean that most fixed trusts don't have a problem with the proportionate approach in the current Division 6. However, some fixed trust deeds do provide for unitholders/beneficiaries to have entitlement to different classes of income or capital gains. For example some fixed trust deeds provide for separate income and capital beneficiaries. Disregarding Division 6E the current operation of Division 6 is not appropriate as the character of the income /gains may not flow through with the distributions to the unitholders/beneficiaries.

We suggest the tax treatment for fixed trusts be similar to the current Division 6 treatment but with a more flexible definition of 'fixed trust' and a provision that allows character retention of different types of income and gains so the tax attributes can flow through to the appropriate unitholders/beneficiaries with clearly defined rights to the particular type of income or gains.

Vested and Indefeasible Trusts

The Government could also consider a total flow through approach for trusts that provide the beneficiaries with vested and indefeasible interests in the income and capital of the trust. Although the *Colonial* case indicated that almost all unit trusts would not fit the definition of 'fixed trust' because they would not have vested and indefeasible interests, there are some trusts that do. If the trust deed does provide such a vested and indefeasible interest there may be a case to treat the trust like a partnership and allow total flow through of all income, capital gains and losses.

Where the interests of the beneficiaries are fixed to that extent, there is a strong argument that they should be treated as directly holding their share of the income and assets of the trust. In these cases avenues for manipulation of the tax system are much reduced and therefore these vested and indefeasible fixed trusts may not need complicated rules designed for other trusts.

Discretionary Trusts

In determining what is the best way to modernise the tax treatment of discretionary trusts we suggest that the Government takes into account that most discretionary trust structures are currently being used by fairly unsophisticated taxpayers and therefore the tax treatment of these structures should be as simple as possible. Unfortunately, trusts by their nature are not simple structures. In particular, the flexibility of discretionary trusts exacerbates the complexity of their tax treatment.

The consultation paper suggests three possible options for the taxing of trusts and trust beneficiaries. Above we have proposed different tax treatment for fixed trusts outside these three suggested options. Therefore, we suggest the three suggested options in the consultation paper be considered only for discretionary trusts.

How each of the three models deals with simplifying the tax treatment of discretionary trusts are discussed below.

Patch model

As the name suggests it is a patch up of the existing rules by simply defining the phrase "income of the trust estate" for tax purposes. There are three options for this definition being:

- Using tax concepts , i.e. align the income of the trust with the taxable income of the trust;
- Using accounting concepts;
- Retain the existing approach of relying of trust law principles but specifically including capital gains.

The 'tax concepts' approach appears to be the preferred option as the other two do not sufficiently deal with most of the problems that have been recognised with trust distributions.

The consultation paper indicates that under the tax concepts approach only the income of the trust that relates to taxable amounts would be used to determine the share of income of the trust that beneficiaries are presently entitled to. It would also require adjustments to account for notional income and expense amounts (such as franking credits) so that taxable income better reflects the amount which the trust actually has to distribute to beneficiaries.

This approach would also require a legislated method of allocating expenses, exempt income and non-assessable non-exempt income.

The defining of income of the trust to be an adjusted taxable income simplifies the calculation of the beneficiaries' share of income of the net income of the trust but it leaves the streaming of income and gains and character retention somewhat open.

The consultation paper does not discuss streaming or character recognition but the example in Appendix A does indicate that Division 6E could be retained to allow streaming of capital gains and franked dividends to specifically entitled beneficiaries. While division 6E was welcomed as an interim measure, its retention on a long term basis is not desirable. It is preferable to deal with streaming on a holistic basis rather than just for capital gains and franked dividends. Division 6E was a patch in itself and the addition of a definition of distributable income as Taxable income could be said to be a patch on a patch.

A proportion within class model

This model more or less reinstates what many tax practitioners considered was the correct approach and what appeared to be the Tax Office's administrative practice until the *Bamford* case.

Under this model, the tax law would identify each type of income derived by a trust and would assign each to a class. Where the trust deed allows the trustee to identify the different classes of income and to allocate the trust's distributable income in each class to specific beneficiaries, the tax law would operate to determine the share of the taxable income to be allocated to the relevant beneficiaries based on their proportionate entitlement to that class of trust's distributable income.

The paper suggests classes could include income and capital items, interest, dividends, primary production income, investment income, business income, and all other income. We suggest while the legislation could prescribe default classes it should also allow the determination of other classes under the trust deed or by the trustee (if the trust deed allows)

The process under this method would then involve:

- Determining distributable income;
- Determining the classes of income for the trust;
- Allocating distributable income to these classes;
- Calculating taxable income;
- Allocating taxable income to the classes; and
- Distributing taxable income across the classes based on the proportionate method.

Where there are undistributed amounts, the trustee would be assessed on those amounts.

This model is consistent with principles most professionals are familiar with and there would be few transitional costs with the model. However, there are further considerations as discussed below.

Definition of distributable income

While the model by its nature would facilitate character flow-through and streaming, the model may still rely on a definition of distributable income similar to the Patch Model. Our preference would be to use adjusted taxable income.

Trust deed amendments for classes of income

The model may also require some trust deeds to be amended to allow the trustee to divide the trust income into the different classes.

Losses

Should losses also be applied according to class? We can understand application of losses by class if this model was being applied to fixed trusts, i.e. where different beneficiaries have clearly defined entitlements to specific class of income or gains. However, as we suggest, this model only applies to discretionary trusts, we don't see the need for any special rules to apply losses on a class basis. We suggest that losses be dealt with the same as other deductions as discussed below.

This model has some significant positives, especially by allowing flow-through and streaming. There may be issues in some trust deeds, but it would be expected that these could be addressed without too much difficulty.

Trustee assessment and deduction model

The TAD model is similar to models used in the US, Canada and New Zealand. In essence, the model is a quantum approach based on distributions of trust income.

Under this model, the trustee calculates the trust's taxable income. Deductions are then claimed for distributions that relate to the trust's taxable income. Any amounts of taxable income that do not relate to amounts distributed to beneficiaries are taxed in the hands of the trustee.

The discussion paper gives examples of deductible distributions as an actual payment of cash or property to the beneficiary or applying cash or property to their benefit. It is not clear from the consultation paper whether the creation of, or crediting to a beneficiary loan account would qualify as a deductible distribution.

As the model contemplates the quantum approach, the beneficiaries would be assessed on the amounts actually distributed. The amounts would retain their character as they flow through the trust, and the beneficiaries would be assessed on that basis. Because of the design of this model, it does not need special rules for streaming. Streaming would be allowed where that power is available in the trust deed. Any undistributed amounts of taxable income would then be assessed to the trustee.

The TAD Model's appeal is that its quantum approach ensures the tax 'follows the money' i.e. the beneficiaries are taxed on the distributions received. However, there are some problems with this model unless certain issues can be resolved as follows.

Definition of 'distribution' under TAD model

Under the TAD model the definition of 'distribution' will be important. We submit that crediting to a beneficiary's loan account should be included in the definition of distribution. Without this, the trustee would have to pay the distributions (in cash or property) to the beneficiaries and if the trust needs working capital, borrow funds back from the beneficiaries (or other sources).

Trustee tax rate under TAD model

Under the TAD model, the tax rate for trustee assessment is important. If the current trustee tax rate of 46.5%, under section 99A, is maintained in the new system this would encourage full distribution of income and gains. If this were the case it would be important to allow distribution by crediting to a beneficiary loan account to allow the trustee to maintain sufficient working capital in the trust.

An alternative is for the rate to be linked to the corporate tax rate, currently 30%. This looks like an attractive model as it would allow the trustee to accumulate income and gains in the trust taxed at the corporate tax. However, there are associated issues with using the corporate tax rate, which are discussed below.

Distributions of trustee taxed amounts

If the trustee is taxed at the corporate tax rate, or any rate below the highest marginal individual rate, there is the question of what happens to subsequent distributions of these amounts. We expect allowing them to be tax free would not be acceptable to Treasury. An alternative would be to provide for the trustee to keep a franking account and allow the subsequent distributions to be franked with franking credits of the tax paid by the trustee. This would then allow the beneficiary to deal with the tax at their own tax rate.

This would allow trusts to accumulate working capital within the trust and cap the tax at the corporate rate until it is distributed to beneficiaries. It may also do away with the necessity of corporate beneficiaries and associated problems of Unpaid Present Entitlements (UPE). However, there may also need to be certain integrity measures similar to Division 7A to deal with loans and use of trust assets provided by the trustee to beneficiaries out of the trustee taxed funds.

An alternative to applying Division 7A to trusts is to restrict the use of the TAD model to trusts that do not provide non-commercial loans or the free use of trust assets to beneficiaries. If a trustee breaches this rule they have to pay tax on the retained income to bring the total tax payable up to the top individual tax rate.

Taxing trusts as companies

While we can see some advantages with setting the trustee tax rate at the corporate tax, it does create further complexities in relation to the taxation of subsequent distributions of trustee taxed amounts (e.g. keeping a franking account) and the need for Division 7A and other integrity measures. With these complexities it may be easier to treat discretionary trusts as private companies so that the imputation, Division 7A and other integrity measures don't have to be reproduced for trusts.

Other Matters

Extended time for trustee determinations

Whatever of the three models is chosen, an important issue for all three models is an extension of the time that a trustee of a discretionary trust has to determine which beneficiaries are to receive distributions from a discretionary trust.

Currently, most trust deeds require the trustee to determine the distributions before the end of the income year. This timeframe is practically unattainable in most cases. We suggest that the trustee be given until the due date for lodgement of the trust tax return to make this determination.

We recognise there are difficulties in this regard, particularly where there are a chain of trusts each with the same or similar due dates for lodgement. However, this would generally only be a problem where the other trust is not part of the family group.

Some trust deeds may need to be changed to accommodate the extension of time for trustee determinations, particularly where there is a default beneficiary that automatically becomes entitled to the income of the trust if the trustee has not determined to distribute to other beneficiaries by the end of the income year. It is suggested that such a change of a trust deed to change the timing of the trustee's determination should not result in a resettlement of most trusts.

Rollover to a company

There is the possibility that with all the changes to the taxation of trusts, some taxpayers may want to dissolve their structures and transfer the assets into a company with the shareholders being the beneficiaries of the trust.

We will suggest a CGT rollover be given to discretionary trusts to rollover into a company (fixed trusts already have this rollover). The shareholders of the new company being the discretionary beneficiaries that pass a "pattern of distribution" test. If Treasury is not prepared to provide such a rollover on an ongoing basis, we would suggest that trustees be given a period (say 2 or 3 years) from the date of enactment of the new law to rollover the trust assets to a company.

In addition the State Governments should be encouraged to provide stamp duty relief for these rollovers.

Amended assessments and nil assessments

The unlimited time frame for amending trustee nil assessments creates uncertainty for trustees and should be rectified on equity grounds. The regular four year amendment time frame should apply to trustee nil assessments. This would bring the treatment of trust income and gains in line with other taxpayers.

Application of section 99B

Under a literal interpretation of section 99B it has a very wide application. We understand that it was introduced to counter the *Union Fidelity Trustee* case, which held that in calculating the taxable income of a non-resident trust for Division 6 purposes, only Australian source income could be taken into account. However, subsequent amendments fixed this problem by amending the definition of 'net income of the trust estate' to say the net income is calculated as if the trustee were a resident. On this basis section 99B does not seem to be necessary to achieve the original policy intent.

The Treasury should consider exactly what the policy was for the introduction of section 99B and whether it is still needed given the introduction of other integrity measures for the taxation of trust income.

Division 6 and the consolidation provisions

A number of issues associated with trusts that are part of a consolidated group for all or part of an income year. These issues are important but the issues are specifically related to consolidated groups and probably should be dealt with outside the review of taxation of trusts.

Family Trust rules

The Family trust rules provide concessional treatment for a number of integrity measures such as the trust loss rules, the holding period rule in the imputation provisions and the trustee beneficiary reporting rules. While the family trust rules have been relaxed in recent years, the requirement to nominate one individual as the test individual still causes problems for some family groups. It is suggested that family trusts be given the option to nominate two individuals from the family group to be test individuals. For example if both husband and wife could be nominated as test individuals it would give equal access to the family trust for both sides of the family.

Treatment of trust expenses

With the acceptance of character retention and streaming it is probably important to provide some rules about the allocation of expenses and other deductions (including previous year losses). This may depend on what option is accepted for the taxing of trusts, but generally, there should be some simple rules regarding the identification of direct expenses and general expenses. Direct expenses/deductions would be allocated against the particular class of income and general expenses should be apportioned on the basis of the income /gains in the class.

Previous year losses from a particular class of income should be allocated to the same class of income but if in subsequent years there is no income in that class, the losses from that class could be treated as general expenses.