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17 February 2012

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

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Dear Sir/Madam

**MODERNISING THE TAXATION OF TRUST INCOME**

We welcome the opportunity to provide comments on the Consultation Paper titled "Modernising the taxation of trust income options for reform" ("the Consultation Paper").

Pitcher Partners comprises five independent firms operating in Adelaide, Brisbane, Melbourne, Perth and Sydney. Collectively we would be regarded as one of the largest accounting associations outside the Big Four. Our specialisation is servicing and advising smaller public companies, large family businesses, small to medium enterprises and high wealth individuals (which we refer to as the "middle market").

**Introduction**

The Government has invited comments and feedback on any aspect of the consultation paper and, in particular, the options for reform outlined in Chapters 7 and 8. In addition to this, the Government has stated that it would welcome comments on 16 specific questions.

Our comments on the 16 specific questions are contained in Appendix A. We have also provided our comments on the options for reform in Appendix B. Appendix C provides a description of supplementary Division 6 issues which are relevant to our

response to Question 2. Appendix D provides some options for considering a reduction in the trustee tax rate.

**Summary of our submission**

For the last five to ten years, the trust taxation regime has undergone a significant amount of scrutiny from the Australian Taxation Office ("ATO"). Due to this high level of scrutiny, a significant amount of uncertainty has been raised in respect of the efficacy of a number of the aspects of the trust taxation measures.

We highlight that, in many cases, the issues raised do not involve revenue concerns. For example, the uncertainty on the scope of Division 6 when there is a bare trust relationship should not be a revenue issue. Accordingly, while we agree that there are a number of uncertainties in relation to the trust taxation provisions, we do not agree that there are significant problems with the way in which the provisions are intended to operate. Therefore, we do not agree that there is a case to justify wholesale reform to the measures. That is, we believe that the measures only require some fine tuning to address a number of the uncertainties that currently exist.

Ignoring the interim measures that were introduced in 2011, we believe that the system that existed at 30 June 2010 generally provided appropriate outcomes for taxpayers and was a system that was generally understood by taxpayers. In our view, the law as at 30 June 2010 should form the base for the re-write, with minor amendments being made to address the uncertainties in relation to those provisions.

We also understand that certain integrity issues may need to be addressed in the measures.

Therefore, we submit that the new measures should be drafted in a manner that is consistent with the proposed proportionate within a class (PWAC) model, i.e. a re-write of the 30 June 2010 measures with a legislative provision dealing with TR 92/13W. We believe that this would be the least intrusive method of reforming the measures and would better achieve the five policy principles contained in Chapter 1 of the Consultation Paper.

While we can see a possible need for wholesale reform from a public interest perspective, it is difficult to recommend significant reforms to the current system as we do not believe this would be in the public interest. That is, given that the reform measures are to be "revenue neutral" under whichever model is chosen, it would seem that the key issues to be addressed are those related to taxpayer administration and compliance, rather than revenue concerns.

Wholesale reform would ignore the practical reality that significant reforms will cause undue unfairness, complexity and compliance for small business taxpayers. We highlight that there are over 660,000 trusts in Australia that lodge tax returns. We also note, as per ATO statistics, that over 95% of those trusts are either "micro" businesses or have no business income or tax losses. Accordingly, the new system will need to be implemented and administered predominantly by small business taxpayers and their advisors. We believe that this would place a significant and

disproportionate compliance cost on small business as compared to the advantages an updated trust taxation regime may wish to achieve from a system perspective.

Furthermore, significant changes to the law which disregard the operation of trust deeds, may also give rise to requirements to amend trust deeds in order for taxpayers to comply with the new provisions. This obviously can give rise to potential stamp duty costs on possible resettlements, in addition to additional taxation and advisory / legal costs. We do not believe that such costs, including disproportionate compliance costs, would be warranted for small business in the current economic climate.

We note that the Consultation Paper is drafted in a manner that suggests the Government may be leaning towards a TAD model to address a number of the issues with the current system. As outlined in Appendix B, we have serious reservations that the TAD model will meet the key policy principles of the trust taxation regime. Accordingly, if the Government does seek to introduce the TAD model, we would strongly recommend that the Government first consult further on the operation of the model to better tease out the pros and cons of the model as compared to the existing model. Only then will the Government be in a place to make an informed decision about the model.

**Trustee assessment income tax rate**

We believe that the punitive top marginal trustee income tax rate has resulted in many of the issues currently being faced with the trust taxation system. This includes issues associated with the treatment of unpaid present entitlements, Division 7A and the ATO's recent concern regarding timing differences.

We believe these issues could be addressed by considering a reduction in the trustee tax rate to either the corporate tax rate (with a credit system) or by providing a reduced final trustee tax rate (e.g. 35%). We have provided further details in Appendix D on both of these options. We do not believe that either of these options will give rise to revenue costs, as we believe that they are simply equivalent alternatives to what is currently offered by the system (i.e. the use of a corporate beneficiary). Furthermore, we believe that a move to a trustee rate of 35% is likely to give rise to an increase in Government revenue in the short term (as outlined further in our submission).

Accordingly, we would encourage the Government to consider these options further during the consultation phase on these trust reforms, as we believe it will result in flow-on improvements to the trust regime.

*** ***

We would welcome the opportunity to meet with you and discuss our recommendations contained in this submission in further detail. Should you have any queries, please contact either Alexis Kokkinos on (03) 8610 5170 or Theo Sakell on (03) 8610 5503.

Yours sincerely

T SAKELL
Executive Director

A M KOKINOS
Executive Director

Encl

# APPENDIX A
# QUESTIONS FOR CONSULTATION

## INTRODUCTION

This Appendix sets out our response to the 16 questions that were raised in the Consultation Paper. We believe that there are a number of relevant issues that require consideration by Treasury in addition to the issues contained in the 16 questions. Accordingly, we have provided our additional commentary and views in Appendix B, Appendix C and Appendix D.

## QUESTION 1. DO THE POLICY PRINCIPLES OUTLINED IN CHAPTER 1 ACCURATELY REFLECT THE EXISTING FRAMEWORK FOR THE TAXATION OF TRUSTS?

Chapter 1 of the Consultation Paper sets out the proposed five policy principles that will be considered in rewriting the trust taxation measures.

However, at the outset, we believe that there is a fundamental, overarching, high level principle that should be recognised in relation to trust taxation. That is, we believe that an effective trust taxation regime should allow trusts to be treated as a complete conduit, so that taxable amounts can be passed through to beneficiaries, whereby the trustee is no more than an administrator of the amounts.

We believe that this "conduit" principle should underpin all other principles. According, the five policy principles should be considered supplementary to, or supporting principles of, this higher level principle.

Our views and comments in relation to each of the five policy principles are provided below.

**1.1.** *Policy principle 1: Tax liabilities in respect of the income and gains of a trust should 'follow the money' in that they should attach to the entities that receive the economic benefits from the trust.*

We believe that this policy principle is aimed at ensuring that there is a mechanism for attributing the tax liabilities and amounts to relevant taxpayers that have received benefits from the relevant trust. We agree that the trust provisions require a mechanism to attribute the taxable amounts to beneficiaries.

*Reservations with this principle*

However it is difficult to ascertain the exact nature of the attribution principle being proposed under the stated policy principle. Of particular concern, is the reference to the term "follow the money", which would tend to indicate a preference for a "quantum" method of allocating liabilities.

We would have strong reservations with such an approach, as a quantum approach will not provide an appropriate outcomes in many cases, including cases where there are amended assessments or cases involving "capital gains tax" assets (discussed below).

We believe that the policy principle should be drafted more broadly, as it will be very difficult for such a policy principle to be satisfied in a number of cases. Accordingly, in our view, we believe that this policy principle should only require tax liabilities to be allocated to beneficiaries in a "reasonable manner".

We highlight that this exact point has been made by our courts in many cases over the last 20 years, including Hill J in Davis v. FC of T[1], Merkel J in Richardson v FC of T[2], Sundberg J in the case of Zeta Force Pty Ltd v FC of T[3] and Bamford v FC of T[4]. In particular, reference is made to the decision of Hill J in Davis, where he stated the following when comparing the proportionate and quantum methods:

> *It is quite clear that neither interpretation of sec. 97 produces a desirable result as a matter of tax policy and the scheme of Div. 6 calls out for legislative clarification, especially since the insertion into the Act of provisions taxing capital gains as assessable income capital gains as assessable income*

Accordingly, it is quite clear that a stringent "attribution" policy that is founded on a follow the money principle will provide anomalous outcomes in many cases. Therefore, we would highlight that care should be taken in drafting such a stringent test as a high level policy principle.

*Problem with "capital gains tax" assets*

Following from the statement of Hill J in Davis, in respect of capital gains, one of our main concerns with this policy principle (as drafted) is the manner in which capital gains would be dealt with under the proposed reforms. Under the proposed policy principle, the retention of capital gains by a trustee would require the trustee to pay tax on the capital gain at a top marginal rate of 46.5%, with the loss of concessions such as the CGT discount and small business CGT concessions. This is because the "money" has been retained in the trust.

Under the current trust taxation system (including the interim measures), there has been a differentiation between taxable gains on income and capital account. The provisions are flexible enough to enable capital profits to be retained in the trust, while the taxable components can be attributed to beneficiaries. Vice versa, the provisions can also allow the taxable capital gain to "follow" the entitlement to the capital gain.

However, the ability to retain capital gains in the trust has helped to ensure that the capital of a trust (that is used for long term reinvestment in other trust assets) can be

[1] 89 ATC 4377 at p.4403
[2] 97 ATC 5098 at p.5111
[3] 98 ATC 4681 at p.4684
[4] [2010] HCA 10 para 17

maintained without the need for a distribution to beneficiaries and the subsequent reinvestment of the same amounts by those beneficiaries. In respect of property trusts, that hold and reinvest in long term property, this is a key commercial feature under the current system. Furthermore, under the current trust taxation system, the ability to retain trust capital with appropriate tax outcomes has also facilitated asset protection for business taxpayers, where it is critical for small businesses to isolate the risks of business ventures from other assets. A "follow the money" principle would create asset protection risks, requiring distributions to be made to "at risk" beneficiaries, requiring such beneficiaries to gift the amount back into a trust. While the tax outcomes would not change (i.e. the beneficiary would still be taxed on the capital gain at discounted rates), the distribution and subsequent gift would place the beneficiary "at risk" in respect of capital that is to be reinvested back into the trust.

*Problems with defining "follow the money" and "economic benefits"*

Essentially, the policy principle refers to concepts such as "follow the money" and "economic benefits" to attribute tax liabilities. The wording used in this principle is similar to the "specific entitlement" model developed during the interim measures that refers to the term "financial benefits" in sections 115-228 and sections 207-58. The term "financial benefit" is defined very broadly in section 974-160 to include "anything of economic value" – thus giving rise to an "economic benefit" model.

While the term "economic benefit" may end up working appropriately when limited only to capital gains and dividends (which has yet to be tested), we are concerned that Treasury may be considering expanding this concept to all forms of income and gains derived by a trust for the purpose of attributing tax liabilities. Our main concern is the ability to make beneficiaries entitled to "financial benefits" as defined in the Income Tax Act, which may not be amounts that can be attributed to a beneficiary under a particular trust deed. Furthermore, we are concerned with the compliance issues associated with requiring trusts to ascertain the amount of economic benefits that have been provided to beneficiaries during a year of income. Accordingly, we are concerned that the outcome of such a policy principle (as stated) may result in a higher incidence of trustee assessments, where the "economic benefits" have not been attributed to a beneficiary.

For example, consider a beneficiary that is provided with the use of trust property at a less than market value rate. This would result in a financial benefit being provided to a beneficiary. This would then require one to value the amount of the financial benefit, which could be disputed by the ATO. The identification of these benefits and the valuation of such benefits would result in unworkable complexity for attributing tax liabilities under the trust taxation system.

Trustees would rarely be required under a trust deed to determine all economic benefits that flow to beneficiaries when determining who to distribute income or capital to, hence the significant increased compliance burden.

Accordingly if, notwithstanding our strong reservations, this policy principle is to be implemented, we stress that care needs to be taken so that the supporting rules that are developed in the legislation (i.e. compliance with this policy principle) are workable and can be applied in practice by trustees of trusts.

*Possible solutions and considerations*

As stated earlier, we believe that the policy principle should simply be one that requires a reasonable attribution to beneficiaries. Accordingly, we believe that the principle should not lock in the manner in which the supporting rules are drafted, but instead be drafted to allow for some degree of flexibility in drafting the supporting principles. We therefore believe that the policy principle could be re-drafted in the following format:

> *"The trust system should provide a manner in which trust liabilities can be attributed to beneficiaries of the trust in a reasonable manner, having regard to their entitlements under the trust."*

Furthermore, the issue of high trustee tax rates and the loss of tax concessions where there are trustee assessments could be addressed (systemically) by either allowing trustees to access tax concessions or by reducing the trustee tax rate. In particular, if a trustee could access the CGT discount of 50% or small business CGT concessions, a trustee would generally be indifferent on distributing capital gains or retaining the capital. While at first, the Government would consider this proposal to involve revenue costs, we believe that this would be minimal. That is, under the current system, trust capital can be retained with an ability to access the CGT concessional tax rates of individual taxpayers; albeit through more complicated means that would require distributions to be unpaid to the individual beneficiaries.

**1.2. *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.***

We agree with this principle in concept. However, in recent times, the Treasury and ATO have tended to address this principle by introducing black letter law that deals with all possible situations. This has resulted in significant complexity in the introduction of recent measures, including the interim streaming measures.

Accordingly, while we support the fact that the provisions should be robust, we believe that this can be achieved by having higher level principles that articulate the objective of the provisions, rather than supporting principles dealing with every type of scenario.

For example, the Consultation Paper raises the issue of whether the provisions should have legislative rules on the allocation of expenses, deductions and losses. If such a rule was introduced, we believe (as highlighted in our response to Question 6) that the principle could state that expenses, deductions and losses should be allocated on a reasonable basis, having regard to a number of factors. This would be in line with case law decisions on the same topic. We do not believe there would be a requirement to provide robust black letter rules on expense, deduction and loss allocation, as there is a significant body of case law that outlines what is reasonable. We note that the interim measures attempted to provide rules around expense and deduction

allocations, which has now resulted in inappropriate trustee assessments in certain cases[5].

Thus, the Explanatory Memorandum or an ATO ruling could provide appropriate guidance on the policy principle, allowing certain safe harbour principles to be adopted. This would be a practical way of dealing with the issue and would provide certainty to almost all taxpayers, as opposed to the uncertainty that is created through complex black letter law legislation.

### 1.3. *The provisions governing the taxation of trust income should provide certainty and minimise compliance costs and complexity; and*

This is perhaps one of the most critical and important policy principles. There are over 660,000 trusts in Australia. The ATO provide statistics on the types of trusts on an annual basis, which has been replicated in the following table[6].

| Trust size | 2007-08 | | 2008-09 | |
|---|---|---|---|---|
| | # | Total business income ($M) | # | Total business income ($M) |
| Loss | 944 | (2,390) | 784 | (2,545) |
| Nil | 384,211 | - | 408,105 | - |
| Micro | 251,752 | 82,945 | 233,517 | 77,551 |
| Small | 19,464 | 78,897 | 17,559 | 70,733 |
| Medium | 3,762 | 88,585 | 3,272 | 75,610 |
| Large | 153 | 22,732 | 120 | 17,180 |
| Very large | 38 | 20,332 | 35 | 18,677 |
| **Total** | **660,324** | **291,101** | **663,392** | **257,206** |

It is important to note that micro trusts are defined as trusts with less than $2 million of business income turnover. Thus, such trusts are either micro small business trusts or only hold passive assets. The above table highlights that there were 636,907 micro trusts (or smaller[7]) in 2008 and 642,406 micro trusts (or smaller) in the 2009 income year. This represented 96% and 97% of all trusts for those income years.

Due to these percentages, the trust taxation system is predominantly administered by small business taxpayers and advisors. Accordingly, it is critical that the measures are drafted with a view to achieving simplicity, and reduced compliance and complexity.

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[5] Refer to the draft NTLG trust subgroup minutes of October 2011, Issue 4.2, http://www.ato.gov.au/careers/content.aspx?menuid=43140&doc=/content/00299501.htm&page=14&H14

[6] Taken from Table 6.1 of "Taxation statistics 2008–09", published by the ATO in March 2011

[7] That is, with either no income or losses

Furthermore, while we understand that the provisions must deal with integrity issues, the development of such provisions must balance compliance with the complexity of such measures. Accordingly, we support this principle and believe that it should be given a higher priority.

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

We agree with this principle. We believe that a reference to character is a reference to the tax character of gains and losses. Given that the flow-through of taxable income to a beneficiary results in tax consequences to the beneficiary, we believe that it is important that a "conduit" system identify the relevant tax character of distributions received.

We note that the strict application of this principle requires that the beneficiary is able to treat the income and gains (so attributed) as being their own. Accordingly, this would mean that concessions that are currently being provided would need to be considered under such a policy principle. For example, it is currently not possible for a non-resident beneficiary to derive (and thus obtain an exemption for) non-taxable Australian property gains through a discretionary trust. However, this would be inconsistent with the policy principle as stated.

Thus, while we advocate that the exemption should be allowed through discretionary trusts and that complete flow-through should be allowed, we understand that this could give rise to revenue costs that would need to be considered by the Government in implementation of the measures. Given the "no overall revenue cost" policy contained in the Consultation Paper, such a measure may require revenue to be collected from other areas. In this regard, we would have reservations if such a measure were to be funded from other revenue raising amendments (e.g. a higher incidence of trustee assessments).

Accordingly, we believe that Treasury may need to consider whether this policy principle is achievable within the current budgetary context and thus whether there is scope to make exceptions based on Government budgetary considerations.

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

Whilst we understand, and generally agree with it, we have a number of reservations with this principle.

To begin with, we believe that the reference to "trusts" is too broadly stated and does not appropriately consider those trusts that are purely transparent. That is, we do not agree that losses should be trapped within a "bare trust" type arrangement and that such losses are undoubtedly that of the beneficiary. We note that, in such cases, the current tax law acknowledges this treatment for capital losses, where section 106-50 allows capital losses to flow through a trust where there is a beneficiary that is absolutely entitled to the asset. Accordingly, we believe that this exception has already been embedded (partly) in the current law.

Furthermore, we note that this principle provides an inappropriate outcome where there is an overall trust loss, yet there may be particular gains that the trust may be required to deal with (for example capital gains or dividends). The fact that a trust has an overall tax loss should not prevent a trustee from being able to deal with or distribute various components of the assessable income derived by the trust. We highlight that the results that occur (due to the higher trustee tax rates) do not replicate a pure conduit system. For example, if negatively geared shares were instead held by a beneficiary, the beneficiary would be entitled to a refund of franking credits.

We acknowledge that this issue needs to be balanced with the complexity of the system. However, we do not accept that the design of the imputation system took into account this wastage of franking credits through trusts when the system was originally designed and that this wastage is an appropriate outcome under a conduit / flow-through trust taxation system. Thus we believe that in the example of negatively geared shares, the inability to flow through the excess franking credits is inconsistent with an appropriate conduit system. Our further comments and observations on wasted tax concessions is contained in Appendix C.

## 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?

### 2.1. *Priority should be given to Division 6 re-write*

Chapter 3 of the Consultation Paper identifies a number of key issues of uncertainty in respect of the operation of Division 6 of the ITAA 1936. That is:

- The scope of the trust provisions
- Clarifying the meaning of some of the key terms used in the provisions
- The requirement to determine entitlements by year end
- Character flow through and streaming
- Dealing with amended assessments and nil assessments
- The treatment of tax deferred and tax preferred amounts

We note that all of these issues relate to the operation of Division 6 and therefore are what we would refer to as critical trust provisions. Accordingly, we agree that it is important to address these issues in the re-write of the provisions as a priority.

While there are other key issues and uncertainties in respect of trusts outside of Division 6, as identified in Chapter 4 and Chapter 5, we would refer to these as issues with supporting provisions. While many of these other issues are important, we believe that they can be dealt with independently to the reform and re-write of

Division 6 (i.e. through a separate process). Please refer to our response to Question 3, where we refer to a similar process that was undertaken by Treasury in respect of the recent TOFA reforms.

Finally, we note that there are a number of additional considerations that we believe Treasury should consider when addressing the Division 6 issues. We have provided these in Appendix C to this submission.

### 2.2. *Additional issues – Division 6 as an exclusive code*

We highlight one important issue that has not been identified in Chapter 3, being whether Division 6 of the ITAA 1936 is an exclusive code. While the ATO have long held the view that Division 6 is not an exclusive code (per IT 2512), this view has been limited to revenue account holders in the past.

There is a growing concern that the ATO could seek to extend this view to other tax preferred distributions of non-revenue account beneficiaries and note that the ATO is intending to release a Taxation Ruling on 12 May 2012 covering "whether section 6-5 of the Income Tax Assessment Act 1997 (ITAA 1997) can apply to distributions from a trust of amounts not included in the net, exempt or non-assessable non-exempt income of the trust[8]".

We believe that, without legislative clarification on the interaction of Division 6 with other assessing provisions, there will be great uncertainty in respect of this issue and also inappropriate outcomes where a beneficiary derives income through a trust. That is, as a trust is a mere conduit, a beneficiary should only be taxed on amounts attributed through a trust as if the beneficiary had derived such taxable amounts directly. Accordingly, other assessing provisions should not seek to tax trust distributions in addition to Division 6, unless there are clear grounds for taxing such amounts (e.g. a specific provision that applies in specific circumstances). We believe that this issue is a core issue and should also be addressed with the other core issues of Division 6.

### 2.3. *Additional issues – Section 100A*

We also believe that section 100A is a core provision that should be clarified in the re-write of Division 6.

As the Paper notes at page 41, section 100A aims to counter reimbursement agreements in the context of 'trust stripping'. Where section 100A is invoked, the provisions can treat the beneficiary as not being presently entitled to income of the trust estate. This can result in the trustee being assessed on the relevant income of the trust estate at penalty rates - through the operation of subsection 100A(4).

However, what is and what is not a "reimbursement agreement" for the purposes of the three and a half pages of legislation comprising section 100A is a matter of some conjecture. For example, in the most recent case to get to the High Court involving section 100A (i.e. Raftland Pty as Trustee of the Raftland Trust v FCT [2008] HCA

[8] Source: ATO's Public Rulings Program as at 16 January 2012

21), the High Court noted that there was a difference of opinion between the members of the Federal Court as to how section 100A applied to a transaction.

In its decision, the High Court agreed with the decision of the original single judge of the Federal Court as to the application of section 100A. This in itself demonstrates how difficult it is to apply and understand the operation of this integrity rule and how the provision should apply.

There have been numerous cases that have sought to apply section 100A in the past including Idlecroft Pty Ltd v FC of T 2005 ATC 4647 (in respect of trust stripping arrangements), East Finchley Pty Ltd v FC of T 89 ATC 5280 (involving distributions to non-residents) and FC of T v Prestige Motors Pty Ltd 98 ATC 424 (involving restructuring arrangements).

Each of those cases contains different facts and conclusions, making it difficult to ascertain the exact circumstances when the provision could be made operative, especially in a family group context. On this last point, it is noted that subsection 100A(13) excludes "an agreement, arrangement or understanding entered into in the course of ordinary family or commercial dealing".

As the majority of trusts are generally operated by small family groups operating micro businesses (as supported by the ATO's statistics in our response to Question 1), one would expect that this exclusion would operate in the majority of cases. However, the phrase "ordinary family or commercial dealing" is undefined and comes from the Privy Council decision in Newton v FC of T (1958) 11 ATD 442 where Lord Denning said:

> *In order to bring the arrangement within the section you must be able to predicate - by looking at the overt acts by which it was implemented - that it was implemented in that particular way so as to avoid tax. If you cannot so predicate, but have to acknowledge that the transactions are capable of explanation by reference to ordinary business or family dealing, without necessarily being labelled as a means to avoid tax, then the arrangement does not come within the section.*

Taking this comment into account, this leaves open the fact that the exclusion may not apply in a lot of cases. The case of FC of T v Prestige Motors Pty Ltd demonstrates this issue.

Many practitioners are concerned that, due to the ambiguity of the provision, the ATO may take a wide interpretation of its application in an audit context and seek to apply it in a manner that is not consistent with the policy principles.

We believe that the need for section 100A should be revisited, especially given the operation of Part IVA and the trust loss rules in many cases. Should there be a need for a provision like section 100A, we believe that the provision must be better targeted to the mischief it is seeking to prevent.

**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?**

We do not believe that it would be practical to deal with all issues contained in Chapter 3 to 5 in a single re-write of the provisions. This would lead to unnecessary long lead times in respect of the re-write of Division 6 (itself).

We believe that the actual reform process should be conducted via a staged process. It is our preference that Division 6 should be re-written as an independent process to amendments to be made to other provisions. Furthermore, this process should occur prior to the review of other provisions. This is because the core operation of Division 6 will have the greatest impact on taxpayers and tax practitioners trying to comply with the new legislation. Furthermore, once the core provisions are known, it will make it easier for interaction provisions to be updated and modified as required. For example, the tax consolidation interactions can be updated once the trust provisions are known.

Once the Division 6 replacement provisions have been developed with some degree of certainty, then we believe the supporting provisions could be developed over a second or third stage. Some of the amendments to the supporting provisions will be mere technical amendments to ensure the re-written provisions can interact properly. Other areas may require further policy considerations. Accordingly, it would be prudent to categorise these provisions from the outset to help with this legislative process and to help prioritise the relevant issues.

We highlight that the process highlighted above was effectively implemented during the TOFA consultation period, whereby a separate "interactions" process review was conducted by Treasury. At first instance, the Treasury released a detailed consultation paper[9] identifying provisions that would require some form of interaction with TOFA. The document also highlighted, at a high level, the amendments that would be required to ensure that the provision operated appropriately. Stakeholders were then invited to comment on the proposals and provide additional items for consideration.

We believe that this process provides a good platform for validating and identifying consequential changes to other areas of the Tax Law.

[9] This paper, titled "Taxation of Financial Arrangements (TOFA) Interactions and Consequential Amendments" is available at the following website: http://tofa.treasury.gov.au/content/downloads/Interactions_and_Consequential_Amendments_January_2007.pdf

**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?**

While it is relatively easy to identify classes of trusts that should be excluded from Division 6, it is often difficult to summarise this class of trust in simple terms or tests.

That is, most would agree that these types of trusts are "transparent" or "bare" type trust arrangements, where the effective owner of the relevant asset can be identified.

Accordingly, while it would be ideal for a general test to be provided under the re-written provisions, we believe that it may be simpler to identify certain classes of trusts that should be excluded.

**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?**

### 5.1. *Trusts that should be carved out of Division 6*

As outlined in our response to Question 4, we believe that the types of trusts that should generally be excluded are typically those where the property of the trust is held absolutely for the benefit of an identified beneficiary (or beneficiaries jointly) and that beneficiary has a vested and indefeasible interest in the income generated from the asset. Typical examples include bare trust arrangements, custodian relationships, constructive trusts created through equitable assignment of property etc.

We note that section 106-50 of the ITAA 1997 attempts to provide a rule to identify these types of trusts for CGT purposes. While the provision has some problems (e.g. it does not seem to deal with joint owners), the provision provides a basis for a general type test that could be developed further by Treasury for all tax purposes.

Should a general approach be difficult to draft, then it would be possible for the Treasury to identify classes of trusts that are excluded from the trust taxation provisions. For example, the provisions could exclude bare trusts, custodian relationships, constructive trusts etc. The provisions could define each of these relationships and exclusions. The regulations could also be used to add to the list of exclusions.

### 5.2. *Other issues and considerations*

Once an excepted trust is identified, we believe it would be important for the Tax Act to also determine the tax consequences for a beneficiary of such a trust for the purposes of the Act. For example, section 106-50 attempts to produce an outcome once a trust is not recognised for tax purposes, by taxing the beneficiary. A general

rule would need to be developed and tested in respect of its application to provisions of the Tax Act outside of CGT.

## QUESTION 6. IS THERE SUFFICIENT UNCERTAINTY WITH THE CURRENT TREATMENT OF EXPENSES TO WARRANT A LEGISLATIVE SOLUTION?

### 6.1. *No requirement for a legislative provision*

We do not believe that there is sufficient uncertainty in respect of the allocation of expenses to warrant legislative solution. It is highlighted that this issue was discussed at the February 2008 meeting of the NTLG Trust Consultation Sub-group, where the ATO was asked to consider how expenses, deductions and losses should be allocated to classes of income. It was well accepted by most at the meeting that (per case law) expenses should be allocated on a reasonable basis. Accordingly, members recommended that the Commissioner issue some guidance (possibly in the form of a practice statement) premised on reasonable allocation with some examples of what is reasonable. We note that no guidance has yet to be issued. Accordingly, uncertainty would have been addressed if guidance had been provided.

In our view, where the ATO issues guidance on an issue, the majority (if not all) taxpayers will seek to apply such guidance to avoid ATO dispute and to ensure that the trust remains compliant. For example, even though many practitioners do not agree with the ATO's view on unpaid present entitlements contained in Taxation Ruling TR 2010/3, in practice it would be unlikely that taxpayers would ignore the ATO's view when dealing with post 16 December 2009 unpaid entitlements.

### 6.2. *Possible ATO ruling providing guidance*

At the very least, we believe that general principles outlining the allocation of expenses and deductions can be taken from the High Court decisions of Ronpibon Tin N.L. and Tongkah Compound N.L. v FC of T (1949) 78 CLR 47, FC of T v Bamford & Ors; Bamford & Anor v FC of T [2010] HCA 10, and Raftland Pty Ltd as Trustee of the Raftland Trust v FCT [2008] HCA 21.

In its decision in the *Ronpibon Tin* case, the High Court (Latham CJ, Rich, Dixon, McTiernan and Webb JJ) provided guidance on direct and indirect expense allocation. The following paragraphs summarise that guidance:

> *… [the] question what expenditure is incurred in gaining or producing assessable income is reduced to a question of fact when once the legal standard or criterion is ascertained and understood. This is particularly true when the problem is to apportion outgoings which have a double aspect, outgoings that are in part attributable to the gaining of assessable income and in part to some other end or activity. It is perhaps desirable to remark that there are at least two kinds of items of expenditure that require apportionment. One kind consists in undivided items of expenditure in respect of things or services of which distinct and severable parts are devoted to gaining or producing assessable income and distinct and severable parts to*

> *some other cause. In such cases it may be possible to divide the expenditure in accordance with the applications which have been made of the things or services. The other kind of apportion able items consists in those involving a single outlay or charge which serves both objects indifferently. Of this directors' fees may be an example. With the latter kind there must be some fair and reasonable assessment of the extent of the relation of the outlay to assessable income. It is an indiscriminate sum apportion able, but hardly capable of arithmetical or rateable division because it is common to both objects. ...*
>
> *The Court must make an apportionment which the facts of the particular case may seem to make just, and the facts of the present cases are rather special. In making the apportionment the peculiarities of the cases cannot be disregarded. The taxpayers are companies. A directorate is necessary. The circumstances were such as to call for some consideration from time to time on the part of the directors of the investment of the money. Thus although the assessable income is only interest on government loans and fixed deposits, it is by no means a mere question of fixing a fair commission rate for handling the business. It is important not to confuse the question how much of the actual expenditure of the taxpayer is attributable to the gaining of assessable income with the question how much would a prudent investor have expended in gaining the assessable income. The actual expenditure in gaining the assessable income, if and when ascertained, must be accepted. The problem is to ascertain it by an apportionment. It is not for the Court or the commissioner to say how much a taxpayer ought to spend in obtaining his income, but only how much he has spent: see per Ferguson J. in Tooheys Ltd. v. Commissioner of Taxation (1922) 22 SR (NSW) 432 , at p 440 ; per Williams J. in Tweddle v. Federal Commissioner of Taxation (1942) 7 ATD 186, at p 190 . The question of fact is therefore to make a fair appointment to each object of the companies' actual expenditure where items are not in themselves referable to one object or the other. (Emphasis added)*

To summarise the decision, under the general principle, if an expense relates directly to a particular class of income, then the expense would be allocated against that income. Where an expense is general, then the expense would be apportioned, on a reasonable basis, against all applicable income classes. This allocation rule has also been discussed in various other cases, including the case of Kidston Goldmines Ltd v FC of T 91 ATC 4538 (refer to the discussion on general versus specific allocation of expenses at pp. 4544 and 4545). Accordingly, under general principles, an expense would be examined to determine whether it was a direct or indirect expense and would be allocated appropriately. This rule would be applied in determining the expenses / deductions that should be applied to the various classes of income of a trust.

We also note that, in a trust context, the High Court has more recently provided comments about expense allocation when there are income and capital classes. In particular, the High Court stated the following in the *Bamford* case (footnotes omitted and emphasis added):

> *… the distinction between income and capital in trust law was a product of the administration of successive equitable estates with the balancing in particular of the concern of those with life interests in the receipt of income and those with remainder interests in the conservation and augmentation of capital. Thirdly, the "rules" which were developed in Chancery regarding apportionment between capital and income of receipts and outgoings and losses largely took the form of presumptions which would yield to provision made in the trust instrument. Fourthly, against this background it was to be expected that the treatment of receipts and outgoings by a trustee would not necessarily correspond with that in a taxing statute such as the 1936 Act. Fifthly, the degree to which a revenue statute adopts or qualifies or supplants the general understanding of terms with a particular application in property law will be a matter of statutory construction, but bearing in mind the caution expressed by Lord Wilberforce in Gartside v Inland Revenue Commissioners that the transfer from one context to another may breed confusion.*

That is, the High Court has recognised in *Bamford* that whatever general law rules exist regarding the allocation of the expenses of a trust, those general law rules would also be subject to the terms of a particular trust deed.

Finally, three members of the High Court (Gleeson CJ, Gummow and Crennan JJ) also observed in the course of their decision in *Raftland*, that not only was the general trust law rule that losses in one year must be made up out of the profits in subsequent years subject to the terms of a particular trust deed, but also the rationale for the application of such a general rule also had to be tested against the facts in question. Reference is made to paragraphs 66 to 69 of that case for a discussion of this issue.

What the above highlights is that there are a number of principles governing the allocation of expenses and deductions in respect of trust amounts. However, there is little guidance or binding ATO view on the application of such principles. At best, the ATO have provided a number of examples demonstrating how expenses should be allocated in IT 2680 and TR 92/13W.

It is therefore safe to say that the practice of expense allocation in the above manner would not be universally applied amongst trusts in the general tax community and that ATO guidance on the issue would help to reduce certainty as to how expenses should be allocated.

That being said, as also outlined in our response to Question 7, Treasury may have concerns where expense allocation between classes of income (or capital) is subject to the deed and the discretion of the trustee. Accordingly, while we do not believe that statutory rules are required to determine how expenses (including deductions and losses) should be allocated, we understand that integrity rules may be required to deal with the case where capital expenses are artificially allocated to classes of income (and vice versa). While we do not believe that this would be a common issue, we provide our views in respect of this in our response to Question 7.

### 6.3. *How should a legislative provision be drafted?*

Should Treasury take the view that the legislation should contain an expense allocation rule, we believe that this rule could be based on the same case law principles outlined in our response above. For example, rules could be developed along the following framework:

- Direct expenses / deductions would be directly allocated to a class where those expenses are directly attributable to the class
- General expenses / deductions would be allocated to all classes on a reasonable basis
- Revenue losses would be applied to all classes on a reasonable basis.
- Capital losses would be applied only to capital gains.

If needs be, the legislation could also require that the allocation be done on a consistent basis from year to year (for example, such a rule is contained in the TOFA provisions see section 230-80).

## 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?

We have concerns with a definition of distributable income that is based on tax concepts. That is, the notion of taxable income may (and in many cases can) act to create a fictional amount that bears little resemblance to economic amounts derived. For example, using a notion of taxable income would require the trustee to deal with the following items:

- While taxation provisions seek to tax realised gains, in many cases, the taxation provisions may seek to tax amounts that have yet to be realised. Examples include CFC attributable income, TOFA accrual income, and Division 16E income.
- The taxing point for many gains may be brought forward under the taxation provisions, where the amount is not represented by realised trust property. For example, the sale of property is realised under CGT event A1 on entering the contract, while the gain on a disposal of property is derived (for ordinary income purposes) on the conclusion of the contract[10].
- The taxation provisions may deny the deduction of economic expenses. That can act to inflate the amount of statutory income, over and above the taxable income of a trust. For example, the incurrence of non-deductible legal fees can result in taxable income that exceeds economic income available for distribution.

[10] See Gasparin v. Federal Commissioner of Taxation (1994) 50 FCR 73

- Notional income and deduction amounts can also increase or decrease the amount of taxable income but have no effect on the economic income derived by a trust. For example, this can occur where the trust derives franking credits, discount components of a capital gain and incurs notional deductions such as Division 43 amounts.

While there are a number of deeds that define income of the trust estate as being equal to section 95 income, we understand that the above issues may give rise to current uncertainties when determining the income and distributable income of a trust under the current law. Accordingly, we highlight that the ATO is seeking to release a ruling on the "meaning of income of the trust estate in Division 6" on 28 March 2012[11], whereby we understand that the ATO will seek to address these issues.

Given that these issues arise by equating income of the trust estate with section 95 income, we would be concerned if this were to become the standard approach for all trusts, especially where the trust deed does not contain a section 95 income clause.

If the notion of taxable income is to be used for the definition of distributable income, then it would seem inappropriate to include the notional amounts outlined above. We therefore question the appropriateness of using the tax concept as a base in first place if a significant number of adjustments would be required to bring the amount back to an economic concept.

Furthermore, where a trust deed requires distributions to be calculated with reference to ordinary income principles, the calculation of distributable income on tax concepts will result in economic decisions being forced to be made based on the calculation of taxable income. For example, a trustee will be required to resolve to distribute amounts to beneficiaries in cases where income has yet to be derived by the trust, which could result in a deficiency of nets assets, solvency issues etc.

We understand Treasury's desire to reduce the ability for a trust deed to determine the amount that is available for distribution to a beneficiary. Accordingly, we acknowledge that it is likely that Treasury and the ATO would be concerned that the calculation of distributable income could be open to a trustee's discretion under the deed (e.g. the re-characterisation of income as capital and vice-versa). However, we believe that this issue can be addressed by the use of appropriately targeted integrity provisions, rather than by defining income of the trust estate.

For example, we understand through the consultation process that the Treasury and ATO are concerned with the exercise of discretions that would either (a) classify income amounts as capital, (b) classify CGT related expenses as being on income account, (c) raise unfounded provisions that would have the effect of decreasing income of the trust estate, or (d) define income with reference to an amount (e.g. $100 or total sales income for the year).

At first instance, we would be very surprised if there would be more than a nominal number of trusts engaged in any of these practices. However, notwithstanding, we would have thought that a provision that prohibits the trust to take into account any of

[11] Source: ATO's Public Rulings Program as at 16 January 2012.

these adjustments in determining the amount of income or capital of the trust estate would seem to deal with this perceived integrity issue. Furthermore, given the vast difference in trusts deeds that exist, this would seem to be a more appropriate way of balancing the integrity concern with the practical ability for trustees to comply with the proposed requirement.

**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?**

*Streaming provisions*

We believe that the provisions should enable trusts to characterise income based on tax characteristics (see below) and that the provisions should enable a trust to stream such classes of (taxable) income to beneficiaries.

We highlight that the interim measures allow the streaming of capital gains and dividends. However, the provisions require a complex application of the trust provisions under Division 6E of the ITAA 1936. We do not believe that this approach is sustainable for more than two classes of income and is not the best approach in the long term.

As highlighted in Appendix B, we believe that it would be more appropriate to use a general streaming approach, similar to that previously contained in Taxation Ruling TR 92/13W. This approach, when coupled with a simple tax character flow through rule, will allow a trust to appropriately stream classes of income to a beneficiary without significant complexity.

*Character retention*

As highlighted above, streaming requires a character identification and retention rule. However, a character retention provision would also have operation even when streaming does not occur. We note that TR 92/13W contained a basic character retention principle, whereby at paragraph 16, the ruling stated the following:

> *"16. In providing for the flow-on of imputation credits when dividend income derived by a trustee is distributed to a beneficiary, the imputation provisions are consistent with the so-called 'conduit' theory of trust income. Under that theory, an amount of trust income distributed by a trustee to a beneficiary retains the character it had when it was derived by the trustee, unless a provision of the trust deed or of any relevant statute provides otherwise. There is judicial authority to support this theory; see Syme v. C of T(Vic ) (1914) 18 CLR 519 and FC of T v. Tadcaster Pty. Ltd. (1982) 13 ATR 245 at 249; 82 ATC 4316 at 4319."*

This paragraph provided a very general basis on which income and gains retained their character through a trust. The principle was used in conjunction with streaming under that ruling to enable the effective flow through of classes of income to beneficiaries.

However, we highlight that such a principle has not always been sufficient for character retention for all of the purposes of the Tax Act as certain provisions of the Tax Act require more than just the income to retain its character through the trust. For example, section 44 refers to dividends paid to a shareholder. The CGT provisions also require that a CGT event happens to you as a taxpayer (per section 102-20). We highlight that provisions such as section 6B of the ITAA 1936 and section 115-215(4A) have operated to overcome this deficiency with a general character retention provision, by also deeming the other aspect to have happened in relation to the taxpayer.

Therefore, the trust taxation provisions should contain a general "tax character" retention provision that ensures certainty in relation to tax character flow-through to a beneficiary. We also believe that the character retention provision should be aligned to tax classes of income. We note that, in accordance with the decision in FC of T v Australia and New Zealand Savings Bank Limited 98 ATC 4850, it would not be possible for a taxpayer to change the tax character of an item of income, expenditure or exempt-type amounts. Accordingly, we do not believe integrity issues can arise in terms of "reclassifying" tax amounts (as this would not be possible). However, as outlined in our response to Question 7, we understand that targeted integrity measures may be used to limit the reclassification of trust law amounts.

*General rule versus statutorily defined classes*

At first instance, we are unsure why statutory classes of income would be required (or even appropriate) under a pure conduit taxation system. That is, as outlined above, a high level principle could be introduced that would be based on tax classes. Therefore, the rule would apply to an income or capital class if it has recognition under the Tax Act. For example, dividend income, interest income and capital gains would all be classes recognised for tax purposes.

We understand that Treasury has raised identification issues during the consultation period. For example, what would happen if the resolutions and accounts referred to a class of "passive income"? However, we do not see this as giving rise to any issues in practice. Provided that the class referred to has recognition under the Tax Act (i.e. passive income may consist of dividends and interest income derived by the trust), then the character retention rule would retain the character of the amounts by reference to those tax classes (i.e. as dividends and interest).

Notwithstanding the above, if Treasury believed it were necessary to have a statutory set of classes (i.e. to provide certainty as to the classes that can be streamed), then a separate consultation process should be used to identify those classes. However, it is difficult to identify those classes that should be excluded from the character retention provisions. Furthermore, such an approach will also give rise to complexity in the application of the legislation, especially where there is uncertainty as to whether a gain is covered by the prescriptive class. For example, would an assessable gain

under the TOFA provisions be classified as being "interest"? Would the answer be the same if the gain or loss is derived on the disposal of the security?

**<u>QUESTION 9.</u> HOW SHOULD LOSSES BE DEALT WITH WHERE CHARACTER FLOW-THROUGH OF DIFFERENT CLASSES OF INCOME IS RECOGNISED?**

Generally, there is no real issue where losses of one class are offset against another class of income. However, practically, this becomes an issue where tax concessions cannot be flowed-through a trust due to the existence of losses of another class of income. For example, where the trust has franking credits or foreign income tax offsets, losses of another class of income (e.g. rental losses) may result in there being no income of the trust estate to distribute to beneficiaries.

An appropriate solution to such a problem would be to allow trusts the ability to carry forward deductions on a voluntary basis. At a bare minimum, we believe that such a choice should be available where excess credits or offsets exist. The ability to choose to carry forward losses (rather than utilise the deductions against income represented by gross-up components) is provided in a limited manner to companies in Division 36. We believe this represents a model that could be adopted to deal with this issue and is unlikely, in practice, to represent a significant (if any) loss to the revenue.

**<u>QUESTION 10.</u> 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?**

As highlighted in our responses to Questions 2 and 3, Chapter 4 of the Consultation Paper outlines a number of provisions that require some interaction with either Division 6 or trust concepts. There are a considerable number of provisions in the Act that would require consideration in addition to those provisions outlined in that Chapter.

We understand that, as a matter of procedure, Treasury would review all provisions of the Act to determine interaction issues that would need to be examined should Division 6 be re-written into the ITAA 1997. However, for completeness, we provide the following list of provisions that were not mentioned in Chapter 4.

- **PAYGI (Division 45 of Schedule 2 to the TAA)** – The Pay-As-You-Go-Instalment provisions include complex rules that determine the instalment amounts of beneficiaries of a trust estate. The operation of these provisions, the transitional measures and the ATO's systems that administer these provisions would need to be considered in close detail.

- **TOFA (Division 230)** – which contains exclusions for equity interests as defined in Division 820-930 (which includes trust interests), as well as a specific exclusion for trust interests in section 230-460. Specific interaction issues with elections and flow through of concessions has been highlighted in the NTLG

TOFA working group, which would need consideration under a re-write of Division 6.

- **Entrepreneurs tax offset provisions (Division 61)** – which contains specific rules for flowing through the offset where trusts are involved.
- **Company COT provisions (Subdivision 165-F)** – which examines the pattern of distribution test for non-fixed trusts when considering a company that is owned by a trust.
- **Averaging provisions (Subdivision 392-A)** – which deals with applying the averaging rules to a beneficiary where a trust carries on the business of primary production.
- **Farm management deposits (Subdivision 393-B)** – which deals with beneficiaries being deemed to be owners of farm management deposit accounts and thus the deductions available for such accounts.
- **Foreign income tax offsets (Division 770)** – which contains specific rules for the flow-through of foreign income tax offset amounts and its interaction with Division 6.
- **Conduit foreign income rules (Division 802)** – which contains a special rule for amounts that are flowed through a trust under Division 6.
- **Thin capitalisation (Division 820)** – which contains specific rules dealing with trust equity, trust interests and control of trusts.
- **Exemption for non-residents on CGT amounts (Division 855)** – which contains an exemption for amounts that are flowed through a fixed trust and specific Division 6 interactions.
- **Supplementary provisions to Division 6** – provisions that specifically interact with Division 6, which include the transferor trust provisions (Division 6AAA), income of minors (Division 6AA), alienation of income (Division 6A), and the interaction with the public trading trust provisions (Division 6C).
- **Proposed CFC provisions** – which contain specific rules for dealing with trusts as well as proposed exemptions for flowing through exemptions through trusts.

As highlighted in our responses to Questions 2 and 3, we believe that a secondary process is required to appropriately identify all provisions that would require some consideration post the re-write of Division 6.

**<u>QUESTION 11.</u> 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?**

We highlight that this is a difficult question to answer, due to the breadth of the question. Furthermore, without knowing the way in which the re-written Division 6 provisions will work, it is very difficult to know whether there will be additional interaction issues based on the current structure of the relevant provisions.

For example, Division 7A contains a number of problems and is significantly complex. One would hazard a guess that the complexity of Subdivision EA and Subdivision EB of Division 7A may not withstand significant and complex changes to Division 6, given its dependency on concepts such as present entitlement, unpaid present entitlement and net income of a trust estate. However, as noted above, one would unlikely be able to test these interaction issues until Division 6 is re-written.

Whilst the interaction of Division 6 and the capital gains provisions is already noted as being an area that may require attention, we highlight that the interaction of Division 6 and the small business CGT concessions is currently particularly problematic - especially since the introduction of the interim measures to ensure that capital gains can be streamed to certain beneficiaries. For example, we highlight that the determination of a significant individual where income and capital has been streamed can often produce anomalous results. We would be happy to provide further details on these interaction issues in due course.

**<u>QUESTION 12.</u> 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?**

### 12.1. *Number of trust regimes*

We believe that once Division 6 has been re-written into the ITAA 1997, there will effectively be three regimes for different types of trusts.

We believe the first regime will deal with "transparent" trusts, whereby the trust will be ignored for income tax purposes and the tax consequences will fall to the beneficiary of the trust. We believe that special statutory provisions would be required to achieve this desired outcome.

The second regime will deal with widely held trusts under the managed investment trust (MIT) attribution regime. This regime will allow such trusts that have clearly defined rights to apply an attribution model, rather than depend on entitlements to

trust income. However, the current Government proposal states that the attribution model will be elective.

For all other trusts, we believe that one single core regime should then be applied to those trusts. We understand that the single regime will not work appropriately for all types of trusts and that special rules may be required for certain classes of trusts. For example measures dealing with deceased estates. However, we believe that these special rules and exceptions should be built into the regime, rather than there be a separate regime for such trusts.

### 12.2. *Preferred model*

The re-write of the trust taxation provisions represents a significant and important reform package for many SME taxpayers. As outlined earlier, over 95% of the 660,000 trusts in Australia are in the micro-small business taxpayer space. Accordingly, one of the main aims of the reform is to provide legislative certainty for taxpayers, whilst trying to reduce complexity and administration costs.

In our view, the above objective can only be achieved if the new provisions are drafted in a manner that is similar to the way in which the provisions were drafted and applied up until 30 June 2010.That is, by having legislative certainty provided in relation to the principles previously contained in TR 92/13W.

We highlight that this proposal is similar to what is referred to as the proportionate within a class ("PWAC") model proposed. We believe that this model achieves the more appropriate outcomes as compared to other models and can deal with integrity issues through minor tweaking.

Our detailed comments on this approach, and its comparison to other approaches, is provided in Appendix B.

**<u>QUESTION 13.</u> 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?**

It is our understanding that Treasury have proposed to define "distributable income" in accordance with a section 95 type concept under the "patch model". We do not believe that this is necessary for a PWAC model. Furthermore, as outlined in our response to Question 7, we have serious reservations in respect of this approach.

Accordingly, we believe that the concept of distributable income should continue to be defined having regard to trust deeds - i.e. that constituent documents should be relevant in determining what is available for distribution to beneficiaries. Furthermore, the trust deeds should be used in determining who is entitled to such amounts at the relevant time.

As highlighted in our response to Question 7, we understand that Treasury and ATO have expressed integrity issues with this approach. Accordingly, we have also

outlined in our response to that question what we believe to be an appropriate mechanism to deal with the perceived integrity issue.

**<u>QUESTION 14.</u> 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?**

Our detailed comments in relation to this question are contained in Appendix B. However, in summary, we are quite concerned by the prospect of an increased number of trustee assessments under the TAD model for a number of reasons. Furthermore, while we highlight that there may be means to address our concerns, these means are untested and thus may give rise to further issues or concerns (from both a revenue and a taxpayer perspective).

We note that trustee assessments will give rise to a number of commercial issues in addition to taxation issues (such as impacts on banking covenants and solvency issues). Furthermore, trustee assessments will not only result in a higher tax rate being applied, but also result in a wastage of almost all tax concessions, including: the 50% discount capital gain concession; the small business CGT concessions; and income tax offsets such as franking credits and foreign income tax offsets.

The wastage issue could, however, be addressed by allowing trusts to take advantage of these concessions when there is a trustee assessment. We do not believe that this would have a cost to revenue, given that we understand it would be rare for a trust to retain such taxable amounts under the current system.

For all other (non-concessional) amounts, it would be possible to apply a lower tax rate to trustee assessments (e.g. 30%), with a corresponding credit for after-tax distributions. We are conscious however that this proposal would give rise to Division 7A issues, which (in itself) would require substantial consideration.

Alternatively, all other (non-concessional) amounts could be taxed at a lower rate of (say 35%), with no further tax being paid by the beneficiaries on after-tax distributions (i.e. a final trustee tax rate). We believe that the introduction of a final trustee tax rate, being higher than the corporate rate, would likely result in higher revenue collections in the first seven years, which would then be balanced out once Division 7A arrangements come to a close. However, provided that the final trustee rate is appropriately balanced, we note that this alternative could eliminate the desire for using corporate beneficiaries and could also result in a reduction in the complexity of Division 7A interactions. Please refer to Appendix D for further comments on this alternative.

However, even if the Government were willing to accept the above propositions, we still note that we have significant reservations in respect of a TAD model. We believe that further detailed testing and consultation would be required before the Government considers utilising such a model.

**QUESTION 15. IF A TAD MODEL WAS ADOPTED, HOW SHOULD THE TAX LAW DEFINE THE CONCEPT OF A 'DISTRIBUTION'?**

Our detailed comments in relation to this question are contained in Appendix B. In summary, we believe that a broad concept of distribution could be adopted under the TAD model.

**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?**

At the very least taxation and stamp duty relief should be available to prevent any trust deed amendments that are necessary as a result of the rewrite causing a resettlement and thus CGT events to occur and/or the disposal of assets such as trading stock or depreciating assets. The Government must seek to negotiate with all states and territories for stamp duty relief to apply. We also believe that an appropriate time-frame should be adopted around the proposed start dates of the provisions. Even if legislation could be completed by early 2013, we believe that an application date of 1 July 2013 would be both ambitious and dangerous (from a non-compliance perspective). We would anticipate that there would be a long lead time around education and system upgrades (both from an ATO and tax lodgement perspective). Accordingly, we believe it is imperative that the Government consider a longer dated start date, which would not occur before 1 July 2014. Furthermore, we would not be opposed to an election to early adopt the measures – similar to the election provided under TOFA. However, such an option would need to be at the taxpayer's discretion and should not be mandatory based on characteristics such as the size of the trust etc.

If significant changes are made to the taxation of trusts, there could be a higher incidence of double taxation (or inappropriate taxation) where the relevant amounts straddle the first year of application. It is difficult to ascertain at this stage whether this would be the case. Accordingly, this issue would need to be considered further once the proposed reforms are decided upon by the Government.

Finally, where the Government accepts a separate regime for "transparent" type trusts, the Government would need to consider the appropriate application date for such trusts. For example, where the regime could be applied by pre-existing trusts and (if so) whether any transitional rules would be required.

# APPENDIX B
# COMMENTS ON CHAPTER 8 AND RESPONSE TO QUESTION 12

## INTRODUCTION

This Appendix provides further detail to our response to Question 12, as contained in Appendix A. In our response, we highlighted that it is our preference for the Government to adopt a model that was effectively the model that existed at 30 June 2010 and had been in effect (from a streaming perspective) for 18 years. Accordingly, this model would be similar to what is described as the PWAC model.

However, our preferred model would not require significant or complex changes. That is, as stated above, the model would be similar to (if not almost identical to) Division 6 in its form prior to the interim changes that were introduced in 2011. Obviously, minor tweaks could be made to the legislation to deal with certain issues such as streaming, character retention, distribution dates, etc. However, we believe these are minor tweaks to the provisions and should not result in overly complex interaction rules, as contained in the drafting to the interim measures.

The PWAC model is our preferred approach, as we believe it more consistent with being able to provide conduit taxation to beneficiaries. That is, it more appropriately taxes beneficiaries on a basis that is consistent with the beneficiary having received benefits directly. This is facilitated by using a proportionate present entitlement system, rather than a quantum distribution system – whereby the proportionate present entitlement follows the true amount of taxable income. That is, where there is an adjustment for any errors or amended assessments, these are flowed through to the appropriate beneficiary. Accordingly, errors or amended assessments are assessed on a proportionate basis to the beneficiary that received benefits during that year, rather than to the trustee – resulting in a purer "conduit" application of the trust provisions as compared to the proposed quantum method.

Taxpayers are also familiar with the way in which the trust provisions operated to 30 June 2010. Accordingly, the PWAC model is likely to result in greater certainty and lower compliance costs if implemented correctly. Furthermore, in Appendix A, we have also outlined ways in which the Treasury could deal with perceived integrity issues with this model (i.e. with respect to the definition of distributable income), without resulting in fundamental changes to the provisions.

In comparison to the PWAC model, the proposed Patch model is overly complicated and will become even more so should the provisions be expanded to cover an ability to stream other classes of income. Accordingly, we do not believe that a Patch (to the current patched) model could be a workable solution in the long run.

Finally, while we understand that Treasury believes that the TAD model would achieve the objectives of a conduit system (as outlined in Section 8.3 of the Consultation Paper), we have some serious reservations that this is the case. These reservations are outlined in our detailed response below. We believe that it would be imprudent for the Government to commit to introducing such a model without

appropriately testing the model with actual live cases or without conducting appropriate consultation on the issues identified with such a model.

## THE PATCH MODEL

The Consultation Paper states that the Patch model is arguably the "least intrusive way to update the operation of Division 6". Essentially, this is because the Patch model would consist of a re-written version of the current provisions (including the interim trust streaming measures), updated to deal with certain issues canvassed in the Consultation Paper.

However, our problem with the Patch model is that it will involve a patch to the current (very complex) patched model. Accordingly, even prior to contemplating any changes to the current regime, the new Division 6E and the relevant streaming provisions have resulted in a very complex set of provisions. Therefore, we are concerned that the provisions would become unworkable if they were adapted and changed to deal with (a) the streaming of other classes of income, (b) changes to the notion of income of a trust estate, (c) distribution extension timeframes, (d) change the present entitlement model, (e) expense allocation issues, etc.

In our view, the complexity of the current patched model and a proposed patch model would render the trust taxation system unworkable for the micro small business taxpayers that are required to apply the system. Accordingly, we do not believe that the proposed Patch model is a realistic option for the Government to pursue.

## PROPORTIONATE WITHIN A CLASS ("PWAC") MODEL

*Description of the model*

Our version of the PWAC model is what we would otherwise refer to as the 30 June 2010 trust taxation model. That is, the provisions would be drafted in the same manner as they were drafted as at 30 June 2010 (i.e. prior to the interim streaming measures), with a legislative backing for the principles contained in TR 92/13W.

Accordingly, section 97 would be redrafted similarly under the ITAA 1997 re-write. Certain additional provisions would then be inserted to deal with various issues such as streaming and character retention (as discussed below). Minor amendments could also be made to deal with other issues, such as clarifying the scope of the meaning of a trust estate.

We do not believe that streaming and character provisions would need to be overly complex and could be based on very high level principles. We believe that this latter approach can work effectively, as TR 92/13W (which dealt with streaming and character retention to 30 June 2010) was based on high level principles contained in six dot points. We note that there were few, if any concerns, raised in respect of the principles for almost 18 years.

*Streaming of all classes under a TR 92/13 approach*

Up until 30 June 2010, the ATO provided a practical way of reconciling the proportionate approach and streaming income through the application of TR 92/13.

The ruling effectively allowed a proportionate approach to be applied within the various classes of a trust. The approach still relied on the operation of Division 6 and section 97, but provided a view as to how the proportionate approach applied when various classes of income was streamed.

We highlight that the ruling used a broad principles based approach in a small number of paragraphs[12], which effectively achieved character retention and the ability to stream (if taxpayers so chose). Where a taxpayer did not stream (or did not qualify for streaming), the ruling required a taxpayer to apply the total proportionate approach. Accordingly, the streaming principles had no application. We see no reason why the same principles could not be added as an adjunct to the section 97 equivalent (to be contained in the rewrite) to facilitate streaming and character retention.

We stress that our approach to the PWAC model would be to effectively retain Division 6 in its form at 30 June 2010, with some modifications, with an addition of the principles in TR 92/13W. We would have serious reservations if the provisions were drafted under a black letter law approach, similar to the changes that were introduced in 2011 to deal with streaming of capital gains and dividends. Given that TR 92/13W operated on high level principles without question for 18 years, we believe that certainty can be provided by simply embedding these high level principles within the legislation.

If this approach were taken, taxpayers would be able to operate their trusts in much the same fashion as they had operated for the last 20 or so years. We believe that this would greatly help to reduce the costs of complying with the rewritten trust provisions. Accordingly, from our perspective, this factor alone provides the greatest weight for using a PWAC model over the other models.

*Other features of the model*

All other features of the model would be based on those described in our response contained in Appendix A. Utilising such features, the following paragraphs discuss the consistency of the model with the five policy objectives contained in Section 1.2 of the Consultation Paper.

*Policy principle one – consistency with a "follow" the entitlement model*

In our view, the use of a proportionate present entitlement model is more consistent with conduit taxation as opposed to a quantum distribution model. Accordingly, we believe that the PWAC model is therefore more consistent with our view of policy principle one in our response to Question 1.

This is because it follows a model that is based on section 96 – that trustees are capable of avoiding taxation by ensuring that beneficiaries are presently entitled to the income of the trust estate. As income of the trust estate is defined with regards to trust deeds, it is therefore possible to satisfy this requirement.

[12] See paragraphs 4 through 11 of TR 92/13.

Furthermore, the model also ensures that taxable income flows through the trust so that the beneficiaries are taxable on the true taxable income derived for that income year. Therefore, if a trustee has incorrectly recorded taxable income, which is later amended, this would generally not result in a subsequent trustee assessment. Instead, the amounts will be taxed in the hands of the beneficiaries based on their proportionate interest in the trust income. This achieves an outcome that would have occurred had the trustee calculated the correct taxable income in the first instance.

Finally, the model replicates what would have occurred if a beneficiary had derived amounts directly. Accordingly, a 50/50 distribution to two beneficiaries produces an outcome that equates to the two beneficiaries sharing in all income and taxable income in equal proportions, or an outcome that would occur if the two beneficiaries were in partnership deriving such income in accordance with Division 5.

*Policy principle two – developing conceptually robust provisions*

In general, we believe that many of the issues that have been raised with Division 6 can easily be rectified through the re-write by providing some certainty in respect of the way in which the provisions apply. For example, distributable income could be defined with regard to the deed and accounting concepts, but could be clarified so that it did not include certain notional amounts such as franking credits.

We note that the ATO and Treasury have now spent a considerable amount of time investigating their concerns with the current Division 6. Accordingly we would be surprised if the provisions could not be re-written in a form that addressed the majority of concerns of ambiguity.

*Policy principle three – reducing compliance costs and providing certainty*

As outlined already, if the PWAC model is drafted correctly, it will effectively result in a trust taxation model that existed at 30 June 2010 (with minor modifications). Accordingly, in our view, the model would result in the least amount of compliance costs for taxpayers in moving to, and adapting to, the new model.

*Policy principle four – retention of source and character*

We do not see the conclusions in respect of this policy principle being any different under any of the models.

*Policy principle five – use of losses*

We do not see the conclusions in respect of this policy principle being any different under any of the models.

## TRUSTEE ASSESSMENT AND DEDUCTION ("TAD") MODEL

In Section 8.3 of the Consultation Paper, Treasury provided a review of the TAD model as compared to the policy objectives of the trust regime. This short analysis seemed to indicate a preference for the TAD model, due to its consistency with the policy principles.

We note, however, that the analysis provided in the Consultation Paper is not only very high level, but we are not necessarily sure that we agree with the conclusions made. Accordingly, in the following sections, we have highlighted a number of our reservations in relation to using this model for the basis of trust taxation. Due to these issues, we cannot provide support for a TAD model at this stage.

If the Government were to seek to introduce a TAD model, these issues would need to be explored in further detail and appropriate testing would need to be conducted. Only after such consultation do we believe the Government could make an informed decision as to whether the TAD model would really achieve the objectives as outlined in Section 8.3.

*Policy principle one – increased trustee assessments*

One of the main reasons for our concern with the TAD model is that a trustee of a trust estate will pay tax (at the top marginal tax rate) on the taxable (but undistributed) income of the trust. Furthermore, any adjustments increasing the net income of the trust in the case of amended assessments will also be taxable to the trustee. We believe that this goes directly against the principles of conduit taxation.

In addition to this, the benefit of most concessions on a trustee assessment (such as CGT discounts, small business concessions and franking benefits) will also be lost under the current Government's policy and drafting of the legislation. This is demonstrated by the following example.

The TAD model requires distributions to be made to beneficiaries in amounts equal to the taxable income of the trust. This may cause an issue where the economic benefits received by the trust for the income year are below the amount of taxable income for the year and in order to avoid a trustee assessment at 46.5% the trustee borrows in order to fund the distributions. This is demonstrated by the following example:

> *Example 1: Trust A derives a net (economic) profit of $100. It has only one asset at 30 June 2014 being cash at bank of $100. Due to timing differences, the trust has a discounted capital gain of $100 and other taxable income of $100 (i.e. $200 in total). The trust has an ordinary income clause.*

Under the current system, a distribution of the $100 would enable the whole of the $200 to be flowed through to the beneficiaries of the trust. Furthermore, the capital gain will be eligible for a 50% CGT discount.

However, under the TAD approach, unless the trustee can distribute $200, the trustee will be assessable on $100 of the net income. Furthermore, the capital gain that would otherwise be a discount capital gain would be taxable on a gross basis as the discount would not be available. In addition, even if the trustee was able to distribute

$200 under the deed, this would require the trustee to borrow an amount of $100 in order to fund the additional trust distribution. This transaction would place the trust into a deficiency of $100, giving rise to other commercial issues.

In our view, one of the principle aims of the trust taxation regime is to facilitate a conduit tax treatment for beneficiaries. Accordingly, this objective would not be achieved where the new trust taxation provisions result in an increased number of assessments to trustees.

We believe that, at a bare minimum, the trust tax system should be able to allow for all of the income to be taxed in the hands of a beneficiary. Where the system is incapable of achieving this objective (i.e. where it is not possible to avoid a trustee assessment), we believe that this would indicate a significant flaw in the proposed system.

This problem with the TAD model could possibly be addressed by having a lower tax rate on undistributed income (e.g. a 30% rate with credits), or a final tax rate somewhere in between 30% and 46.5% (e.g. 35%)). However, the reduction in rate would not be sufficient on its own.

That is, as highlighted above, trustee assessments will also result in a loss of tax concessions that would otherwise be available to beneficiaries. We would find the TAD system unacceptable if such concessions were denied in the case where a trustee is forced to pay tax on taxable income that cannot be distributed due to the way in which the provisions have been drafted (i.e. using the concept of taxable income as distributable income).

*Policy principle one – amended assessments and distributions*

We do not agree with the statement in the Consultation Paper that states the TAD model is "directly consistent with the first policy principle for taxing trust income — that tax liabilities in respect of the income and gains of a trust should 'follow the money". Take the following example:

> *Example 2: Trust A derives $100 of accounting profit and $100 of taxable income in Year 1 and Year 2. Trust A distributes $100 to Beneficiary A in both years, within the time required. In Year 4, the ATO seek to amend the Year 2 assessment, on the basis that a capital gain of $100 should have been recorded as a taxable profit in Year 1 on entering into the contract.*

In this example, the trustee has distributed all amounts to Beneficiary A. However, despite the actual profit of $100 in each year having been distributed to Beneficiary A a notional amount of $100 will be taxable to the trustee in respect of year 1 as the amended taxable income is $200 and only $100 was distributed. It is noted that this outcome does not occur under the proportionate (present entitlement) model.

> *Example 3: Trust A derives $100 of accounting profit and $100 of taxable income in Year 1 and Year 2. Trust A distributes $100 to Beneficiary A in both years, within the time required. In Year 4, the ATO seek to amend the Year 1 assessment, whereby it is argued that the capital gain of $100 should have been recorded as a taxable profit in Year 2 on entering into the contract.*

As in Example 2, in this case Beneficiary A has received $200. However, the TAD model seems to suggest that a deduction will only be available a year of income up to the amount of taxable income derived in that year. In this case, the $100 distribution in Year 1 would not result in a deduction and would not result in a carry forward loss. Accordingly, $100 of taxable income would be assessable to the trustee in Year 2 – i.e. the amended taxable income for this year will be $200 but only $100 will have been distributed to Beneficiary A within the time required.

In other words, while Beneficiary A has received a distribution of $200, $100 would be taxed at a punitive rate in the hands of the trustee. Again, this example is at complete odds with the policy principle of "follow the money".

*Policy principle one – commercial issues*

We highlight that there are a number of commercial issues associated with the proposed TAD system, simply because it will not meet the objectives of policy principle one.

As highlighted by example 1 above, in order to avoid a trustee assessment, trustees may be required to borrow in order to fund distributions (i.e. where net taxable income exceeds income of the trust estate). In many cases, the borrowing and subsequent distribution will result in the trust having a deficiency of net assets.

Alternatively, should the trustee choose to be assessed on the excess the trustee would still need to fund the tax payable, equal to 46.5% of the taxable income accumulated. As the net taxable income would not be supported by real income and assets, this would also place the trustee into a deficiency of assets. Accordingly, this could give rise to potential solvency issues for the trustee and thus potentially exposing the directors of the trustee to personal liabilities.

Furthermore, trustee assessments, or a requirement to distribute in excess of net assets, may also result in trusts breaching their banking covenants.

Accordingly, we are concerned that the TAD model, which should be a model for allocating tax liabilities to beneficiaries, will give rise to significant commercial issues and consequences for existing trusts.

*Policy principle two and three – trust deed amendments*

The TAD model would represent a fundamental change to trust taxation. The Consultation Paper states that:

> *"By clearly defining key concepts and reducing the reliance of the tax law on individual trust deeds, the model also supports the second and third policy principles — that the tax law should be conceptually robust, more certain and simpler."*

Given that little reliance would be placed on individual trust deeds under a TAD approach, we are concerned that it may not be possible for existing trusts to comply with the new provisions without appropriate trust deed amendments.

However, such deed amendments may result in a resettlement. Not only can such amendments result in income tax consequences (which admittedly could be dealt with under this review by way of a resettlement exception), but may also trigger significant stamp duty consequences. This may occur, for example, where the trust is land rich. While the Government could request the States to provide stamp duty relief, it would not be possible for the review to address this issue.

Given that there are over 660,000 trusts that derive taxable income in Australia, we are concerned by the inadvertent tax imposts that may occur should trust deed amendments be required to comply with the new system.

We therefore believe it is critical that the Treasury properly road test the TAD model, with a view to determining whether actual trust deeds will need to be amended in order to comply with the basic proposed principles under a TAD approach. Without performing this testing, the TAD model is likely to produce unintended outcomes and will also likely result in higher compliance costs for trusts wishing to ensure flow-through taxation can be achieved.

*Policy principle three – educational issues*

As highlighted in our response to question 1, we note that there are over 660,000 taxpayer trusts in Australia, whereby approximately 96.5% of such trusts are considered micro-business trusts.

It is therefore evident that the trust taxation system is predominantly administered by small business taxpayers and advisors. Accordingly, any significant change to trust taxation will result in an immense amount of training and education required for our taxpaying community. This gives rise to a potentially significant risk of error and non-compliance in the short to medium term. We therefore have reservations that this will achieve the stated policy objective three.

# APPENDIX C
# FURTHER COMMENTS ON ADDITIONAL ISSUES

## 1. Determining present entitlement

*Determining entitlements*

For the purpose of Division 6, we understand that a number of issues resolve around determining the entitlements of beneficiaries. These range from whether the entitlement has been perfected and actually exists (i.e. which is important from an audit context in determining which party is actually allocated the taxable income), whether it is possible to make taxpayers entitled to notional amounts, and whether extra time should be granted after year end to create entitlements. We believe that each of these issues could be addressed without fundamentally changing the current present entitlement model.

As noted earlier, we believe that the present entitlement model is the more consistent with the principles of a conduit taxation system as compared to a distribution model, as the latter will always result in trustee assessments as soon as a distribution is insufficient to cover an amount. Accordingly, where amounts change post-distribution, the distribution model is incapable of adapting. Essentially, this is because the distribution model is static, while the present entitlement model is dynamic in respect of tax outcomes. Therefore, inadvertent tax outcomes can occur if distributions are based on factually incorrect information.

*Perfecting entitlements*

As noted above, issues with a present entitlement model can be addressed. For example, it is understood that in the context of an audit, it is sometime difficult to determine exactly who was entitled to the income of the trust estate. Section 101 provides a type of rule that is aimed to overlook actual present entitlement and instead look at what was intended by the parties – however, this rule does not go far enough in perfecting present entitlement in many of these cases. Accordingly, improvements to a section 101 equivalent could help to deem present entitlement where it would not otherwise occur.

*Present entitlement versus specific entitlement*

We do not believe that there needs to be a general move to a specific entitlement rule and that the present entitlement rule deals with the majority of cases. We believe that the specific entitlement rule is overly complex in its application and can produce unfair outcomes in certain instances. However, we believe a special rule may be required for capital gains due to their special nature.

**2. Providing extra time to determine who is presently entitled to income**

We believe that it is imperative that Treasury address the "30 June" entitlement requirement under the re-write. This requirement produces enormous pressure on taxpayers and advisors to complete their distributions by 30 June. This typically involves unnecessary compliance associated with preparing interim accounts, estimating year end amounts, and documenting the distributions by 30 June.

Accordingly, in line with extra time provided to private companies to make franked distributions after year end, extra time needs to be provided to trustees in relation to their distributions.

We understand that Treasury has indicated in consultation that this may give rise to issues where the beneficiary is another trust. That is, the distribution may not form income of the other trust and may not be available for subsequent distribution.

On this point, we highlight that this is more of a problem for the TAD model as compared to any other model, as it is unlikely that a TAD model could work using a 30 June distribution date. That is, if the TAD model relies on actual distributions of amounts, it would be impossible for a trustee to make distributions of exact amounts at year end where accounts have yet to be finalised at that time. Accordingly, it will become an imperative under the TAD model for extra time to be provided. This will also increase the taxable income of the recipient trust (who will also need to distribute that income).

We believe there are ways in which this issue could be addressed, ranging from the way in which the extension is drafted (e.g. documentation prepared within four months of year-end will evidence present entitlement for the purposes of the Act), to provisions deeming the amount to be income of a prior year, to deed amendments to also deem the amount to be income derived of a prior year. Accordingly, we believe that Treasury should engage further on how this would be achieved.

Finally, provided the issues above can be resolved, we believe that where a trust is a closely held trust (e.g. it has made a family trust election) we see no practical problems with providing the trust with an extension of time until the lodgement of its return. If beneficiaries have earlier lodgement dates, this issue will be administered appropriately by the trust. For all other trusts, we believe that the four months provided to private companies in section 202-75(3) sets an appropriate precedent for extra time.

We acknowledge that trust deeds may need to be amended to allow such flexibility (i.e. if they currently require present entitlements to be created prior to 30 June). However, such trusts will have a choice to distribute before year end (subject to the comments above in respect of the TAD model). Furthermore, new trusts can be established with the added flexibility.

## 3. Dealing with Division 7A interactions

We note that one of more significant issues with Division 7A is its interaction between companies and trusts where there are present entitlements. The use of so called "bucket" companies has resulted in a plethora of legislation, ATO rulings and practice statements. However, we note that (potentially) this issue can be addressed by reducing the trustee assessment rate to the corporate rate (currently 30%). That is, the reduced trustee rate would reduce pressure on the use of a bucket companies and would likely result in an elimination of unpaid present entitlements going forward. This may result in the application of Division 7A to the trust itself. However, as the trust would continue to be a flow-through vehicle for all other (non-retained) amounts, Division 7A would be limited to the retained taxable profits of the trust.

We believe that this would be a worthwhile interaction issue to be considered as part of this review, as this could potentially resolve a number of Division 7A interaction issues.

## 4. Dealing with wasted credits and tax losses

Where a trustee is assessed under section 99 or 99A, a trustee will generally either waste franking credits or tax losses against such credits. We submit that this is contrary to the conduit principle, as such credits would not be wasted if they were derived by a beneficiary directly. Accordingly, a trustee should be able to get full benefits of franking credits (in the form of a refund or conversion to tax losses) even if there is a trustee assessment – for example trustees that borrow money and negatively gear shares should be able to use franking credits in the same way as an individual and a company.

The following example is used to demonstrate the issue associated with the wastage of credits.

> *Wastage of credits*
>
> *Trust A derives $70 of franked dividend income and $70 of expenses. The grossed up dividend is equal to $100 for tax purposes. The trust has net income of $30, however there is no income of the trust. Accordingly, the trustee is assessed on $30 at 46.5% (i.e. $13.95) and will receive a franking credit of $13.95 (due to the non-refundability of the credit). This results in a wastage of franking credits of $16.05.*

This outcome is inconsistent with the conduit theory. That is, if an individual beneficiary had derived the franked dividend directly and incurred the expenses directly, the individual would have been entitled to a refund of excess franking credits. Furthermore, if the income of the trust had instead been $1 (i.e. expenses had been $69 instead of $70), then the distribution of $1 to an individual would have allowed the whole of the franking credits to flow through to the individual, together with tax being assessed on the beneficiaries marginal rates rather top rate of marginal tax.

The following example is used to demonstrate the issue associated with the wastage of tax losses (and credits):

> *Wastage of tax losses (and credits)*
>
> *Trust A derives $70 of franked dividend income and has $100 of carry forward tax losses. The grossed up dividend is equal to $100 for tax purposes. The trust has net income of $0. In this example, tax losses and franking credits are wasted in the trust.*

Compare this result to that of a company. Under section 36-17, the company does not waste its $100 of losses and retains the use of the franking credits for a future distribution. This is clearly an appropriate result.

Compare this result to an individual. While the individual will utilise its tax losses, the individual will receive a refund of the franking credits of $30. This again is clearly an appropriate result.

The wastage of tax losses together with the wastage of credits by a trust is inconsistent with the conduit theory when compared to the results that would otherwise occur for a beneficiary receiving the distribution of franked dividends directly.

Alternatively, the ability to choose not to utilise carry forward tax losses or current year tax losses, in a manner similar to the rules contained in Division 36 for companies, could also help reduce the instance of credit wastage and tax loss wastage.

## 5. Section 99B

We agree with the Paper that the scope of section 99B needs to be clarified in light of the fact that more than 30 years after its introduction into the 1936 Tax Act there is still considerable uncertainty as to the correct interpretation of this provision and whether it is confined to distributions of accumulated income from non-resident trusts.

In the case of Traknew Holdings Pty Ltd v FCT (1991) 21 ATR 1478, Hill J outlined that the introduction of the provision was intended to apply to distributions of accumulated income from non-resident trusts. However, Hill J did not conclude on the breadth of the provision, by stating that it "is not necessary to decide for the purposes of the present case whether the extreme width of s. 99B and associated sections require it to be read down having regard to the obvious legislative purpose in enacting it".

Apart from a reference to the above judgment in Weyers v FCT [2006] FCA 818, where Dowsett J stated that "it is not necessary that I address this question", there appears to be no other court decision where the scope of section 99B has been considered in the context of an Australian resident trust. We note that the recent decision of Howard v FCT (No.2) [2011] FCA 1421, which resulted in the application of section 99B in the context of a foreign trust does not assist in determining the scope of the provision.

It is therefore uncertain whether section 99B achieves its intended application and whether the provision would be consistent with the policy principles under a wide interpretation of the provision.

In our view, section 99B needs to be repealed and re-drafted in a manner which narrows its scope to the original intent of the provision – i.e. to tax the distribution of accumulated post Australian residency income from non-resident trusts.

# APPENDIX D
# TRUSTEE TAX RATE

*Background to the penalty rate for trustee assessments*

Section 99 has been part of the 1936 Act since its introduction. The provision is based on an equivalent provision in an earlier Tax Act, namely, subsection 31(2) of the Income Tax Assessment Act 1922-1935. Subsection 31(2) stated that:

> *... a trustee shall be separately assessed and liable to pay income tax in respect of that part of the income of the trust estate which if the trustee were liable to pay tax in respect of the income of the trust estate, would have been the income of the trust estate remaining after allowing all the deductions under this Act ... and (a) which is proportionate to the interest in the trust estate of any beneficiary who is under a legal disability; or (b) to which no other person is presently entitled and in actual receipt thereof and liable as a taxpayer in respect thereof.*

In 1964, parliament enacted anti-avoidance legislation following the report of the Ligertwood Committee. As a part of that legislation, measures were introduced to target the problem where taxpayers had been establishing multiple trusts for the same beneficiary or group of beneficiaries. The income was directed to be accumulated and the income of each trust was separately taxed under section 99 as though it was the income of an individual. Under the system of graduated rates of tax at the time, each trust paid little or no tax. Were the income of each trust to be aggregated, much higher tax would have been paid. Accordingly, in 1964, it was only the abuse of the long-standing choice to accumulate the income of a trust which led to the introduction of a 50% tax rate via section 99A.

The solution adopted in 1964 was to bring in a new section 99A under which accumulating trust income was taxed at a penalty rate of 50 per cent. Such income would not be taxed under section 99A, but at individual rates under section 99 if the Commissioner, on the basis of guidelines in the law, exercised a discretion to do so. The intent was that legitimate trusts would be taxed in the old way, but tax-avoidance-inspired trusts would be taxed at the penalty rate.

In other words, prior to 1964, the scheme of the provisions regarding the taxation of trusts was that the net income of a trust was taxable at the relevant marginal tax rate in either the hands of the beneficiaries (if it was distributed to a beneficiary who was not under a legal disability) or the trustee (if it was accumulated / distributed to a beneficiary who was under a legal disability).

As highlighted in the High Court decision of Bamford, the operation of the current provisions in this manner is facilitated through the key operative provision of section 96. Section 96 states that "except as provided in this Act, a trustee shall not be liable as trustee to pay income tax upon the income of the trust estate" (emphasis added). Section 99 (and now section 99A) provides the clear exception to the taxation of beneficiaries. The operation of section 99 in this manner was explained in the High Court decision of Whiting in 1943.

> *Reading the sections as a piece of English, I think it reasonably plain that in the case of a beneficiary who is sui juris all that is necessary in order to attract liability to him and to divert it from his executor or trustee is that he should be presently entitled to income of the estate.*

In turn, further subsequent abuse of the 50% tax rate under section 99A resulted in the highest marginal tax rate being imposed in 1977. That is, as a separate measure in 1977, the rate of tax under section 99A was increased to the maximum rate of personal tax, 60 per cent, because some groups had been using the section 99A rate of 50 per cent to shield family income from that higher maximum rate.

It is noted that, during the period of 1940 to 1986, company taxation was subject to the classical system of tax. The company tax rate ranged from 47.5% in 1940 to 49.0% in 1986. However, where a company made a distribution to an individual, such profits would be subject to an additional layer of personal tax once distributed by the company. Accordingly, where rates of personal tax were 60%, a distribution through a company to an individual would have resulted in effective tax rates of between 75% to 80%.

Accordingly, the corporate tax rate was hardly seen as the comparative rate to be used as the penalty rate for trust taxation, as no groups would utilise a corporate beneficiary due to the punitive rates already imposed through that structure at the time.

*Reducing the rate to 30% with credits*

With the introduction of the imputation system in 1987, and with the introduction of full refundable credits in 2000, the corporate tax payable (at an entity level) has been effectively capped at 30%. Given that a business could operate through a company and achieve a 30% tax rate, it is questionable why the trustee rate should be any greater than 30% where income is accumulated at an entity level. That is, provided that subsequent distributions to individuals from a trust were to be taxed at the marginal rates of the individual (taking into account any tax already paid by the company), it is unclear why a penalty rate over and above 30% would be imposed. Furthermore, if a business was established such that a company was wholly owned by a trust, profits could be accumulated in the company (and thus effectively be accumulated in the trust by way of unrealised profits on the shares) at an effective tax rate of 30%.

As outlined above, the trust system of taxation has always provided the option for trustees to accumulate income. The punitive rates have only been introduced to address certain tax avoidance issues – i.e. in 1964 and 1977. However, since that time, taxation rates in Australia, especially in respect of the taxation of business income through a company, have been reduced dramatically and allow for appropriate flow-through of tax at the corporate level via the imputation system. Accordingly, changing the trustee rate of tax is unlikely to introduce anti-avoidance activity in respect of trusts.

Furthermore, if a trust were subject to a 30% tax rate, we would envisage that this could be complimented with rules that are similar to Division 7A to ensure that "taxed profits" of a trust would not be lent to an individual to avoid top-up tax at marginal

rates (see Appendix C). Accordingly, the policy for maintaining a trustee penalty tax rate of 46.5% is highly questionable in today's taxation climate.

*Reducing the rate to 35% as a final tax*

An alternative to the 30% tax rate / credit option is a reduction in the punitive trustee rate to something that is more reasonable having regard to the current taxation climate in Australia. Accordingly, instead of using a final tax rate of 46.5%, we believe that it would be more appropriate to consider a reduction in this rate to something closer to 35%.

A 35% rate is effectively the present value rate of taxing the trust income at marginal rates of approximately 42%, in seven years time. Essentially, seven years equates to the time period in which an unpaid present entitlement to a corporate entity (that is taxed at 30%) can remain unpaid under a trust beneficiary agreement that is consistent with PSLA 2010/4 for the purpose of Division 7A. However, we note that the rate of 35% is conservative, given the use of a relatively high average marginal rate of tax and the fact that the timing of dividends from a corporate entity is discretionary and not mandatory.

The advantages of using a final tax system are numerous. That is, it obviates the need to apply Division 7A to trusts, as no further tax would be payable by the beneficiaries. Furthermore, if the trust rate is established as a realistic rate (e.g. 35%), it is unlikely that trusts would seek to use corporate beneficiaries going forward. While the rate would result in an additional cost to taxpayers (upfront), this will only be a timing difference. Furthermore, such a measure would save compliance requirements and administration cost under Division 7A. Finally, the modification would likely give rise to a significant increase in revenue in the short term – noting that this would likely balance out after seven years (i.e. as there may be a reduction in top-up tax collected on the payment of corporate dividends representing unpaid present entitlements).

We highlight that this system of using a final tax rate for trustee assessments is one that is used in New Zealand. It is noted that a similar tax rate as proposed (as compared the New Zealand corporate rate) is used.

As a final note, we highlight that this option is intended to be of benefit to SME taxpayers. Accordingly, we see no reason why this option should be extended to non-closely held trusts. Obviously, the risk associated with a blanket reduction in the trustee rate may be a shift in public companies to trust structures. This may have a fundamental revenue effect. Accordingly, our proposal is simply aimed at private groups. Therefore, we believe it may be appropriate to only provide such a reduction to trusts that have made a family trust election.