Submission re Modernising the Taxation of Trust Income – Options for Reform

The following points arise as we review the November 2011 Consultation Paper on the subject of Modernising the Taxation of Trust Income - Options for Reform.

The points which following are in no particular order though broadly following the matters covered in the Consultation Paper -

1 The Consultation Paper identifies 'the issues' that have evolved in recent years in relation to trusts, the most significant of which being the inter-action between distributable income and taxable income evident post Bamford[1].

The question nonetheless arises whether wholesale reform is required.

It is submitted that the law in relation to the taxation of trust income is now largely certain; anomalies can largely be avoided; and manipulation relatively easily identified and able to be addressed via existing anti-avoidance provisions.

In the context of the above, could a minimalist approach overcome many of the issues identified in the Consultation Paper?

It is submitted that such an approach could.

Please refer Appendix 1 where we seek to set out Observations on a principle by principle basis having regard for the five policy framework principles.

Interestingly the above was developed before reading paragraph 8 and its three models. In effect, the above is analogous to the 'Patch Model' but without the need to define the term 'Income of the Trust Estate' but, as Appendix 1 makes clear, adopting anti-avoidance provisions where there is manipulation.

2 On page 3 of the Paper, four key issues requiring immediate attention are identified. Expressly excluded from those issues is "the current issues with the legislative definition of 'fixed trusts'...". These are to be examined through a separate process.

As the decision in *Colonial First State* illustrates, the legislative definition of 'fixed trusts' is impractical. The day to day difficulties that this is incurring and, more particularly, the additional uncertainty, compliance cost and complexity that it is causing is such that if it is to be examined outside this process but through a separate process, then it must be in parallel with a resolution being introduced at the same time as any reforms arising out of this immediate process.

In this context, it is noted that one of the five principles that are part of the policy framework include that "trust losses should generally be trapped in trusts subject to limited special rules for their use".[2] It is impracticable to have this as a key principle and not have the 'fixed trust' issue resolved as part of this process.

On page 3 of the Paper it is stated that the Government welcomes comments on the appropriate scope of this review. It is submitted that the concept of 'fixed trusts' is fundamental to this review and ideally should be part of its scope or, at worst, resolved in parallel.

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[1] One could be forgiven for suggesting that the Australian Taxation Office and/or Treasury have sat on their hands for many years given that the Bamford outcome became an apparent risk as early as the decision in *Zeta Force*.
[2] Consultation Paper, Page 2

3 Page 5 of the Paper notes that *"trusts are used across a broad range of industries, particularly in industries that are characterised by small and family businesses"*.

The reforms should have direct regard for the impact on "small and family businesses" particularly in the concept of providing certainty and minimising compliance costs and complexity which is one of the five principles noted earlier.

4 A very important consideration is to identify the tax agent constituency that is likely to have to deal with any implemented reforms and to carefully consider their ability to understand and accommodate those changes. Many, if not by far the majority, of trust tax returns would be prepared by less sophisticated accounting firms which will find it considerably more difficult to come to grips with significant legislative change.

5 In paragraph 2.2, the current rules that generally govern the taxation of trust income are broadly set out.

In paragraph 2.27, the concept of "tax preferred amounts" is identified and explained.

Its focus is upon income for trust law purposes that is not assessable income.

In reality, commercially, there are two types of tax preferred amounts being that identified in the paragraph and also income for trust law purposes that is included in assessable income but which is effectively excluded from Section 95 net income because of tax law timing differences. Accelerated depreciation for tax purposes is perhaps the most common example.

As paragraph 2.27 notes in the last paragraph thereof, there can be CGT cost base adjustments arising because of tax preferred amounts.

In practice, the difficulty often experienced is that where the distributable income is higher than the taxable income because of timing differences, those cost base adjustments arise, but do not reverse when the timing difference reverses. This is an anomalous outcome that needs to be considered in the context of these reforms.

6 Further, in the context of tax preferred amounts, the discussion in paragraph 2.27 indicates that an entitlement to a tax preferred amount may be ordinary income in the hands of a beneficiary and brought to tax through the ordinary income provisions, referring by way of example to ATO Interpretative Decision 2011/58 and Taxation Ruling IT2512.

In particular, in the context of that comment, ATOID 2011/58 is very troubling because it is potentially easily extrapolated to, at its worst, ordinary mums and dads who invest in order to generate income streams to fund their living.

The question in ATOID 2011/58 is whether amounts distributed...to a unitholder...can be included in the unitholder's assessable income under Section 6-5...*if the amounts have the quality of income in the hands of the unitholder?* (Italics added) This question has the potential to apply to far broader circumstances than that of a resident general insurance company investing premiums in order to derive a return to meet future liabilities.

In the context of the third principle identified on page 2 which, among other things, seeks to 'provide certainty', an outcome of this process should be that Division 6 is an exclusive code.

7 In the context of the first discussion point above regarding paragraph 2.27, it is noted that ***Note 1*** in ATOID 2011/58 implicitly acknowledges the two types of tax preferred income outlined above.

8 The discussion in paragraph 2.27 also identifies the possibility that Section 99B may technically apply to include tax preferred amounts in the assessable income of the beneficiaries of a trust though going on to say that "we understand that this would be rare in practice".

It is further noted that clarifying the scope of Section 99B is contemplated in the discussion in paragraph 7.6.

This should be an imperative as it should not be appropriate that there is a provision which, broadly, technically applies, but which is only applied in what might be described as a default scenario.

It is noted that the application of Section 99B is also discussed in paragraph 3.7. This highlights the concerns just raised.

9 Further to the prior point in relation to the scope of Section 99B, similar considerations arise in relation to the operation of Section 100A. This is a provision crafted with a very wide ambit where the reality is that it is not applied technically but, rather, applied pursuant to its terms in, generally, abusive situations.

10 In the context of the discussion in paragraph 3.6 regarding the scope of Division 6, there is discussion regarding bare trusts and custodial trusts.

In a day to day commercial sense, a common feature of many property partnerships and/or joint ventures is that the underlying real estate is held by a nominee for the benefit of the partners or joint venturers as the case may be. Such an approach is usually designed to facilitate day to day transactional activity so that rather than every partner and/or joint venturer being required to execute transaction documents, a single nominee does so on their behalf. Typically, that nominee is a company.

In an equities investment and/or trading context, custodians are increasingly common with responsibilities to the parties for whom they act in relation to the safe keeping of assets, the independent recording of the assets for the benefit of those parties, independently settling transactions on behalf of the parties, producing transaction and holding reports, producing taxation reports and generally producing various forms of compliance and/or management reporting reports. Nonetheless, practically, these custodians are mere conduits.

To look through custodians produces practical outcomes reflecting the substance of the commercial circumstances.

Legislative clarification in respect of custodians is a commercial imperative.

11 Also in the context of the discussion in paragraph 3.6 regarding the scope of Division 6, we also note PS LA 2000/2 which among other things exempts a trustee from the obligation to lodge and income tax return for a Transparent Trust - a trust in which the beneficiary of the trust estate has an absolute, indefeasible entitlement to the capital and the income of the trust.

12 Paragraph 3.2 focuses upon the meaning of key terms in Division 6 and seems to promote that they should be supported by, among other things, definitions and object clauses because the "...lack of common understanding about the meaning of these terms - as shown by continued litigation decades after their introduction - has contributed to a rise in complexity and compliance..."[3].

It is a feature of legislation generally that terms cannot be precisely defined and there will always be possible extremes in interpretation.

The concepts of general deduction and income have been in the legislative provisions well beyond the period that Division 6 has been in those provisions and those concepts are still subject to continued litigation.

Definitions and objects clauses should not be seen as a panacea, more so as there is a move away from black letter law to in principle drafting, as a means of legislative drafting. Principles based drafting contributes to a rise in complexity because of the uncertainty it generates.

13 In relation to the discussion and commentary regarding, broadly, character flow-through and streaming, there is no consideration of Section 6B of the 1936 Act.

Very broadly, that Section, which generally operates for the purposes of the Act, might be said to ensure character flow-through.

14 Paragraph 5.3 asks "whether the family trust rules should be simplified...".

In this respect, two points are raised in the context of the 'test individual' concept -

14.1 Such elections can only be made whilst a test individual is alive; and

14.2 It is presently uncertain whether what is required to establish this election is one or both of a trustee resolution and/or lodgement of the relevant form.

An anomaly can arise where, for example, a new trust is established during a financial year intended to be part of a family group by the making of such an election and the test individual passes away before, at the latest, the required form is lodged with the trust's tax return.

This can lead to unintended consequences such as the distribution from a trust within a family group to a new trust in anticipation of the latter becoming part of the family group with, as a consequence, the imposition of family trust distribution tax.

Further, there is the prospect that post the death of the test individual, family structures are required to have two group, one being by reference to the Family

[3] Consultation Paper, Para 3.2 at page 10

Group established whilst the test individual was alive and the second being by reference to new entities coming into existence and outside that Family Group post the test individual's death. This generates unnecessary complexity and compliance risk.

15 Paragraph 6 contemplates the possible approaches to reforming Division 6. In paragraph 6.1 there is the statement that "...it is important to compare the benefits of any changes with the potential costs, including transitional costs".

It is also important to ensure that taxpayers who have implemented trust structures on the basis of Division 6's operation, and particularly having regard for long standing ATO practice, should not be materially disadvantaged.

In this context and subject to commenting below regarding the different approaches that could be adopted, any new approaches should ensure that -

15.1 The taxation of tax preferred amounts does not change;

15.2 Character flow through and 'streaming' should still be possible;

15.3 Determining present entitlement after year end is permitted;

15.4 Section 99B should only apply where accumulated foreign source income is distributed to a resident beneficiary; and

15.5 The withholding regime for dividends, interest and royalties should be maintained.

16 Paragraph 6.2 identifies that Appendix B includes a brief summary of the different approaches that have been adopted internationally.

We have sought to summarise these different approaches in Appendix 3 and consequently note -

16.1 Internationally trusts are generally used for personal investment matters;

16.2 Regarding the taxation of trust income, as a generalisation, it is ultimately taxed at individual rates either because beneficiaries are taxed on distributions received or, alternatively, because trusts are taxed and then beneficiaries are, broadly, relieved of tax on amounts received to the extent to which tax has been paid by the trustee; and

16.3 Character flow through is generally retained.

17 We endorse the concept of "...a single model that achieves the desired outcome in the vast majority of cases and a 'workable' outcome in more unusual circumstances...".[4]

Having said that, we note particularly the need for specific attention to be given to deceased estates (at least during the early years post death), disability trusts (for the

[4] Consultation Paper at page 28

benefit of a person who suffers from a defined mental incapacity or serious physical disability), charitable trusts and managed investment trusts.

18 In terms of the interaction between distributable income and the taxable income of a trust estate, there is concern about anomalous outcomes and opportunities to manipulate. Putting to one side for a moment the need to address anomalous outcomes, has considered attention been given as to whether other provisions of the Taxation Law satisfactorily address "opportunities for manipulation"? Until recently the only example given deals with an exempt entity being assessed on amounts received by capital beneficiaries. At first blush, one would have thought that it is not too difficult to identify a counter factual that would facilitate the identification of a tax benefit and a dominant purpose to avoid tax as a consequence of which the general anti-avoidance provision in Part IVA would have application.

In this context, Paragraph 8.1 refers to "manipulation based on the deliberate creation of a mismatch between distributable and taxable income...". If this is what is to be attacked (and we agree that it should be) then existing anti-avoidance provisions should address this.

19 Paragraphs 6.41 and 6.42, among other things, contemplate the calculation of what is described therein as 'Trust Amounts' or 'Income of the Trust Estate' (in current parlance).

There is a fundamental difficulty here given that trusts are governed by the terms of their Deeds with those Deeds determining amounts to which beneficiaries are entitled.

The concept of a statutory trust amount would mean that taxpayers and their advisors would have to grapple with -

19.1 The distributable income of the trust as determined pursuant to the Deed;

19.2 The taxable income of the trust; and

19.3 The statutory trust amount.

Presently, the first two of these need to be addressed by taxpayers and their advisors.

One of the policy principles of minimising compliance costs and complexity would be defeated if a third amount had to be considered.

20 When discussing the 'Proportionate within class' model, in paragraph 8.2.5 there is a statement that where trusts "...do not currently distinguish between classes of income, the model may actually increase complexity and compliance costs".

This comment would seem to suggest that allocation to the relevant classes is mandatory. Does this need to be so?

Why could it not be left to Trustees to determine whether or not to allocate to classes?

21 When reading the commentary in Part 8.3 re Trustee assessment and deduction and comparing it with Proportionate within a class, paragraph 8.3 seems to go out of its way to self justify the satisfaction of the five principles. There is no such commentary in Part 8.2 dealing with Proportionate within a class.

It is submitted that the Proportionate within a class method conceptually meets the principles just as the Trustee assessment and deduction model does.

22 The Trustee and assessment model also states that it "...could clearly state whether amounts retain their character and source when they are distributed...". This could equally apply to both the patch model and the Proportionate within the class model.

23 There is a question in paragraph 8.3.1 whether the Trustee assessment and deduction model might require a Section 100A like provision.

It is not immediately seen why this is limited to this model and not equally applicable to the other two.

24 Paragraph 8.3.4 states that the Trustee assessment and deduction model "reduces complexity and compliance costs by avoiding the need to apply detailed trust concepts such as 'income of the trust estate' and 'present entitlement' in order to determine the tax liabilities of the beneficiaries and trustees of the trust;".

With respect, this is misguided because as noted in paragraph 8.3.1, there is still a need to define 'distribution'.

In substance, a distribution is ultimately going to be no different to a 'present entitlement'.

25 Further, the concept of 'income of the trust estate' is important because, as the discussion also illustrates, it is going to be necessary to identify where the taxable income has been distributed to beneficiaries and thus to require some form of matching between the distributable income to the beneficiary and the taxable income attributable to that distributable income.

That same paragraph also states that this model would 'reduce the scope for beneficiaries to be taxed on amounts that they are not entitled to...'.

In paragraph 8.3.1, it provides that the 'size of the deduction would reflect the taxable income related to the amount distributed...'.

That statement:

25.1 Identifies the need to attach taxable income to distributable income; and

25.2 Prima facie, does not state that the taxable income amount can never be more than the amount distributed.

26 It is difficult to comment fully in relation to the Trustee assessment and deduction model in the absence of specific examples that, among other things, deal with -

26.1 The tax rate applicable to Trustees where this is residual taxable income;

26.2 The treatment of franking credits in the hands of the Trustee;

26.3 The treatment of capital gains in the hands of the Trustee;

26.4 The treatment of beneficiaries when there is a later (after the Trustee has been assessed) distribution to beneficiaries; and

26.5 The taxation treatment of notional taxable income such as attributed foreign source income generally and, more particularly, when that income is derived by the trust either because of a distribution to the trust or because of a disposal of the underlying asset.

27 Overall, it is submitted that there is insufficient detail in the Consultation Paper in relation to the Trustee assessment and deduction model as a basis for meaningful comment.

28 In Appendix 2, we have sought to conceptually compare the three models against the five principles.

Having regard for our comments in this Paper, our preferred model is the Patch model.

Appendix 1

Principle	Observation
'Follow the money'[5]	• Trusts are governed by their deed or terms. This is a necessary starting point in the determination of the 'assessment' process; • In terms of the interaction between distributable income and the taxable income of a trust estate, there is concern about anomalous outcomes and opportunities to manipulate. Has considered attention been given as to whether other provisions of the Taxation Law satisfactorily address "opportunities for manipulation"? Until recently the only example given deals with an exempt entity being assessed on amounts received by capital beneficiaries. At first blush, one would have thought that it is not too difficult to identify a counter factual that would facilitate the identification of a tax benefit and a dominant purpose to avoid tax as a consequence of which the general anti-avoidance provision in Part IVA would have application. Such an approach would largely mitigate this concern;
Conceptually robust[6]	• Incorporate provisions dealing with trust expense attribution; • Exclude notional income and expense amounts from forming part of distributable income; • Amend CGT event E4 so that the difficulty often experienced is that where the distributable income is higher than the taxable income because of timing differences, those cost base adjustments arise, but do not reverse when the timing difference reverses. This is an anomalous outcome that needs to be considered in the context of these reforms;
Provisions should provide certainty and minimise compliance costs and complexity[7]	• It is impracticable to have this as a key principle and not have the 'fixed trust' issue resolved as part of this process; • Permit formal determination of present entitlement after year-end (by due date for tax return lodgement).[8] • Clarify the scope of Section 99B; • Require a 'dominant purpose' for the purposes of Section 100A; • Provide legislative protection against the issuing of assessments many years later; • an outcome of this process should be that Division 6 is an exclusive code; • Clarify the tax consolidation interaction;

[5] 'Follow the money' – tax liabilities should attach to the entities that receive the economic benefits from the trust, Consultation Paper at page 2;
[6] Conceptually robust to minimise both anomalous results and opportunities to manipulate tax liabilities, Consultation Paper at page 2;
[7] Consultation Paper at page 2;
[8] This would require collateral changes to trust deeds, where the deed would permit same, which should not constitute a resettlement

Character and Conduit principles should be clear[9]	• This is largely a policy decision. If character and conduit principles, which most trust deeds permit, are to be permitted for taxation purposes, at all, and then, either broadly or narrowly then this can be mandated. The more recent reforms re franking and capital gains streaming are evidence of this possibility.
Trust losses trapped subject to special rules for their use[10]	• Address the issues that evolve as a consequence of the death of a 'test individual';

[9] It should be clear whether amounts obtained by the trustees [retain] their character and source when they flow through, or are assessed, to beneficiaries, Consultation Paper at page 2;
[10] Trust losses should generally be trapped in trusts subject to limited special rules for their use, Consultation Paper at page 2.

Appendix 2

<table>
<tr><th>Principle</th><th>Patch</th><th>Proportionate within a Class</th><th>Trustee Assessment and Deduction</th></tr>
<tr><td rowspan="2">‘Follow the money’[11]</td><td colspan="3">Every model is going to require:
• The trust deed or terms as a necessary starting point in the determination of the ‘assessment’ process;
• A taxable income computation;
• A definition of entitlement;
• To the extent character[12] flow through is permitted, expense allocation and financial and tax account segregation;
•</td></tr>
<tr><td>Achieved, if necessary by applying appropriate anti-avoidance provisions where "manipulation based on the deliberate creation of a mismatch between distributable and taxable income..."[13].</td><td colspan="2">Achieved, with the support of anti-avoidance provisions where required.</td></tr>
<tr><td>Conceptually robust[14]</td><td>Achieved if supported by provisions dealing with trust expense attribution and by excluding notional income and expense amounts from forming part of distributable income;</td><td colspan="2">Achieved</td></tr>
<tr><td>Provisions should provide certainty and minimise compliance costs and complexity[15]</td><td>Achieved because founded on current law; minimal change and limited transitional impact</td><td>Whilst a variant on the Patch model this model still requires significant change and significant transitional impact.</td><td>As a ‘significant departure from the current operation …”[16] this requires even more significant change and significant transitional impact.</td></tr>
</table>

[11] ‘Follow the money’ – tax liabilities should attach to the entities that receive the economic benefits from the trust, Consultation Paper at page 2;

[12] In addition to classes this also includes a reference to exempt income and non-assessable non-exempt income

[13] Consultation Paper, Paragraph 8.1;

[14] Conceptually robust to minimise both anomalous results and opportunities to manipulate tax liabilities, Consultation Paper at page 2;

[15] Consultation Paper at page 2;

[16] Consultation Paper, Paragraph 8.3.4 at page 42’

Character and Conduit principles should be clear[17]	Each could clearly state whether amounts retain their character and source when distributed. Confirmation of acceptable methods of dealing with trust expenses would be required.		
Trust losses trapped subject to special rules for their use[18]	Achieved	Achieved but possibly more complex if class losses.	Not considered in the Consultation Paper.

[17] It should be clear whether amounts obtained by the trustees [retain] their character and source when they flow through, or are assessed, to beneficiaries, Consultation Paper at page 2;
[18] Trust losses should generally be trapped in trusts subject to limited special rules for their use, Consultation Paper at page 2.

Appendix 3

International Conceptual Comparison

	United States	Canada	United Kingdom	Ireland	New Zealand	South Africa
Primary use of trusts	Used for personal and business matters	Used for personal and investment matters	Used for personal and investment matters	Used for personal matters	Used for personal and investment matters	Used for personal and investment matters
Taxation of trust income	Beneficiaries taxed on amounts distributed. Trust taxed on the balance after allowing a deduction for amounts distributed.	Beneficiaries taxed on amounts distributed. Trust taxed on the balance.	Trusts taxed. Beneficiaries taxed on amounts received adjusted for tax paid by the trustee.	Trusts taxed. Beneficiaries taxed on amounts received adjusted for tax paid by the trustee.	Trust taxed Beneficiaries taxed on amounts received adjusted for tax paid by the trustee.	Beneficiaries taxed on amounts distributed. Trust taxed on the balance.
Character flow through	Character retained	Dividends interest and taxable capital gains retain their character.	Character retained	Loses its character.	Character generally retained	Character retained.
Losses	Not specified	Trapped and carried forward.	Not specified	Not specified	Not specified	Trapped and carried forward.