NATIONAL SECRETARIAT

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Trustee Corporations Association of Australia

14 February 2012

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

Dear Sir

Taxation of trust income

The TCA is the peak representative body for the trustee corporations industry in Australia.

It represents 16 organisations, comprising all 8 regional Public Trustees and the great majority of the 11 private trustee company groups.

Each year our members:

- administer about 9,000 deceased estates.
- write about 60,000 wills and powers of attorney.
- manage assets under agency arrangements or Court and Tribunal orders for about 45,000 people.
- manage about 2,000 charitable trusts and 15,000 other personal trusts.
- prepare over 40,000 tax returns.

We appreciate the opportunity to comment on the consultation paper *Modernising the taxation of trust income – options for reform.*

Introduction

While the consultation paper covers a wide range of situations and issues, our focus is on what would seem to be the most appropriate approach for the great bulk of members' business.

That core business covers deceased estate administration, testamentary trusts and fixed trusts.

Given the number of taxation returns that members prepare each year, we are keen to ensure that the time required for each return is kept to a minimum.

We support the paper's fundamental premise that 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.

Life tenant beneficiaries, for example, should not be taxed on capital gains that they will never receive.

Most of the trusts managed by members are relatively simple in nature, with little streaming of income in the context discussed in the consultation paper.

Entitlement to capital and income in such trusts usually can be established before 30 June, so it is generally quite clear as to when income should be taxed in the hands of the trustee rather than the beneficiary.

However, in some cases this cannot be determined until post-30 June and the trustee should not be forced to allocate income without all the necessary information.

One issue is whether tax should be based on distributions only or on present entitlements - it is noted that the TFN/closely held trusts arrangements are based on present entitlements.

In the case of 'simple' trusts, we feel that the first two options in the consultation paper would involve a considerable amount of work for trustees.

We would prefer a variation of the 3rd option in the paper - the 'trustee assessment and deduction' (TAD) model, whereby a beneficiary's tax is calculated not only on distributions / benefits received, but also on amounts to which beneficiaries have a vested and indefeasible interest, to avoid unwarranted trustee assessments.

However, in the case of deceased estates, we would recommend that a beneficiary's tax be calculated only on distributions / benefits for the first 3 years of an administration, to avoid situations where beneficiaries may be taxed on amounts they are yet to receive.

We believe that this would also simplify the taxation of deceased estates during the various stages of administering a deceased estate which is currently subject to IT 2622.

Detailed discussion

<u>The Trustee Assessment and Deduction Model</u>

We believe that the TAD model (option 3) is to be preferred for preparing income tax returns of trusts. Showing amounts distributed to beneficiaries as a deduction to the trustee is the most straight forward approach to determine taxable income of the beneficiary and trustee.

Whilst this model represents a departure from the current methods of preparing income tax returns, we believe trustees and their tax agents will adapt quickly given the amount of changes that have taken effect over the last two of financial years.

The TAD model appears to be the least problematic in terms of compliance costs and complexity.

It may, however, increase trustee assessments, very often to the detriment of the beneficiary if the tax rates on distributed income and undistributed income are different. However, as the paper notes, there may be ways of dealing with this in cases where such an outcome is unreasonable.

Appendix A of the consultation paper provides one example where the trustee instead of the beneficiary will be assessed under this model.

Another example would be where the beneficiary has a vested and indefeasible entitlement to the income of the trust and the trustee does not distribute funds - not to minimise taxation, but simply because funds are not needed by the beneficiary. A court order (compensation award) trust, held until a minor beneficiary turns 18, is a good example of such a trust.

The calculations given as examples demonstrate how complicated and time consuming trust tax returns will become if the Patch model and the Proportionate within Class models are implemented.

In deceased estates, streaming of taxable income occurs as a result of different assets being bequeathed to different beneficiaries. The income from these different assets are blended together under s95 and taxed in the hands of specifically bequeathed beneficiaries according to s97 as it currently stands, with its character flow through problems. Deceased estates and our other trusts will also have "notional" income and expenses such as franking credits and capital works deductions.

The complex calculations under the first two options will therefore be relevant to many of the trust and estate tax returns lodged by our members.

The first two options may achieve the end result of allowing streaming, etc but the complexity will be so high that even tax agents will have difficulty understanding and applying the law. It will lead to increased costs of compliance, a lower rate of compliance, more errors and poor decision making.

The risk that these options are attempting to address (deliberate creation of a mismatch between taxable and distributable income) have no relevance to the thousands of deceased estates, testamentary trusts and court order/compensation type trusts. Income re-classification or re-characterisation clauses are not relevant for these deceased estates and trusts.

<u>Patch model</u>

As the example in Appendix A demonstrates, the calculations required under the Patch Model - to adjust distributable income in relation to notional income and expenses and capital gains, working out adjusted division 6 percentages in relation to specifically entitled assets and then working out the distribution of taxable income - will increase the time taken and complexity for a significant number of our tax returns.

The level of complexity will be so high that recruitment and training of new staff will become an even greater problem, particularly if they are not tax agents.

Proportionate within class model

This model, in addition to time consuming calculations, will require costly adjustments to established trust accounting systems and training of trust accounting staff who are not familiar with tax concepts.

Deceased estates - Reviewing Taxation Ruling IT 2622

IT 2622, concerning present entitlement during the stages of administration of deceased estates, states that beneficiaries cannot be presently entitled to income derived by a deceased estate during the administration of the estate. Only when an estate has been fully administered by payment of testamentary expenses, duties, annuities and legacies and the amount of the residue thereby ascertained, can beneficiaries be presently entitled.

The ATO have accepted a method of apportionment in the income year in which the estate is fully administered. Where the executors and beneficiaries are able to demonstrate, through the striking of accounts at the completion of administration, the actual amounts of income derived in the periods before and after the day on which the estate was fully administered, an apportionment may be made between the executor and the beneficiary (ies).

As this exists only as a Taxation Ruling, it would be an opportunity missed to exclude this from any review in the modernisation of the trust taxation laws in determining Entitlement to Trust Amounts.

A taxing method similar to the TAD model should be adopted during the stages of administering a deceased estate - at least up to 3 years from date of death. From a tax law design perspective, the benefits of simplicity will outweigh the few occasions when less tax will be paid by the beneficiary on undistributed s97 amounts. When applying the ‘ability to demand payment’ test (as needed for present entitlement) to deceased estates during administration, there are many additional factors that must be considered compared to other on-going trusts.

Time limit for determining entitlements

We feel that having to make resolutions by 30 June is impractical given that the final distribution and tax information from managed fund, unit trust and stapled securities investments generally does not issue until late July/early August.

Rather, formalising the unofficial practice of allowing resolutions to be made up until end August would be more reasonable.

Separate rules for taxable, exempt and non–assessable non-exempt income

We believe that the treatment of Exempt and Non–Assessable Non-Exempt Income should have stand alone entitlement clauses.

This will ensure an equitable taxable position for beneficiaries that receive this type of income.

Family trust rules

On 20 March 2006, the then Assistant Treasurer announced that the government intended to amend the income tax law to allow income beneficiaries of testamentary trusts (such as life tenants) greater access to franking credits on dividends received by trusts. It was proposed that beneficiaries of testamentary trusts who have a vested interest in the dividend income of the trust but not the current beneficial ownership of the underlying shares were to be excluded from the franking credit holding period rules.

The amendments to give effect to this announcement still have not been introduced.

This amendment should be enacted to apply to trusts types that are listed in s102AG *ITAA1936*. This will create a fairer and more equitable system as we do not believe these types of trusts are used as tax avoidance vehicles and feel they were unintended victims of the Family Trust rules.

Section 99/99A Commissioner's discretion

Section 99A(2) *ITAA 1936* states that concessional tax rates are available to trusts that result from a will, court order, bankruptcy or those types listed in s102AG(2)(c) *ITAA 1936*, only "if the Commissioner is of the opinion that it would be unreasonable that this section should apply in relation to that trust estate in relation to that year of income."

Under the self-assessment system, there is an expectation that trusts such as testamentary trusts will receive concessional tax treatment for amounts assessed to the trustee. This expectation may be too presumptive if there is a possibility that the Commissioner decides not to exercise his discretion.

We feel that this grey area must be addressed to ensure that trustees are given some certainty as to what tax liabilities they can expect in any particular year.

CGT Event K3

Section 104-215(1) *ITAA 1997* states that CGT event K3 happens if a person dies and a CGT asset they owned just before dying passes to a beneficiary of their estate who (when the asset passes) is an exempt entity.

There appears to be an anomaly in this section whereby assets passing to a testamentary trust endorsed by the ATO under subdivision 50-B *ITAA 1997* as an exempt charitable fund will trigger a K3 CGT event, however assets passing to an endorsed deductible gift recipient do not trigger a K3 CGT event.

The endorsement process of under subdivision 50-B ITAA 1997 ensures that tax exempt funds are created primarily for charitable purposes.

We firmly believe that an endorsed charitable fund should not be penalised for receiving an asset passed via a will. As such, we request that an amendment be made to s118-60 *ITAA 1997* to disregard a capital gain or loss for testamentary gifts to an entity endorsed by the ATO under Subdivision 50-B *ITAA 1997* as an exempt entity.

Trustee beneficiary non-disclosure tax on share of net income

Division 6D of *ITAA 1936* concerns trustee beneficiary non-disclosure tax where no correct TB statement is provided in the income tax return of a closely held trust where a trustee beneficiary is entitled to a share of net income.

We propose that a de-minimis threshold similar to that provided by section 12-185 *TAA 1953* (for beneficiary payments from closely held trusts) apply also to trustee beneficiaries payments from closely held trusts.

Take the example whereby a small payment can be made to the estate of a deceased life tenant from a testamentary trust. Under the current measures, the estate must have a tax file number to receive the full amount as there is no exemption. On some occasions, this receipt is the only amount the estate is to receive.

We believe a small exemption would assist trustees of closely held trusts as well as executors of small deceased estates without having a genuine impact on taxation revenue.

Beneficiaries with a legal incapacity

Trustee companies and Public Trustees act as trustee in many trusts for incapacitated beneficiaries due to the beneficiaries' lack of capacity to attend to financial and taxation matters on their own account.

Section 98 of ITAA 1936 provides that, where a beneficiary under a liability is presently entitled to income of a trust estate, the trustee of the trust estate will be assessed and liable to pay tax.

Section 100(2) provides that tax paid by the trustee in respect of the interest in the net income of the trust estate shall be deducted from income tax assessed against the beneficiary.

This ensures that the trustee is assessed and that payment of the tax is made from the income of the trust estate.

However, by virtue of s67-25(1B), a trustee assessable under section 98 is not eligible to recover excess imputation credits. Rather, the beneficiary who lacks capacity is required to apply for it themselves. As a consequence, many dividend imputation credits remain uncollected and are forfeited.

Clearly this impractical requirement of persons with a disability is an unintended consequence of the existing provisions, which should be rectified as part of the current review.

Self assessment

We believe that trustees should be given the opportunity to self assess whether a trust return should be lodged.

Under the current rules a return must be lodged irrespective of the amount of income derived.

There would be a number of deceased estates/testamentary trusts which our members administer where the income is being assessed to trustee as 'no beneficiary presently entitled', but this income is below the tax threshold.

The majority of these estates/trusts are of very low value and primarily relate to bequests left to children, which are payable provided the child survives the testator and attains a specified age.

A similar situation could also apply where the income from a trust is assessed to a minor beneficiary who is deemed to be 'presently entitled but under a legal disability' but the income is also below the relevant tax threshold, particularly if this is their only source of income and they are not required to lodge an individual return.

The cost of preparing these returns has to be charged against the trust, which means that by the time the child becomes absolutely entitled there is nothing of their bequest left, or the trustee must apply a very small charge which is not commensurate with the time taken to prepare and lodge.

Currently, limited exemptions apply to some trustee organisations but only where:

a) the trustee is not taxable, and;

b) there is no distribution to a presently entitled beneficiary who is not under a legal disability.

Where there is a distribution to a presently entitled beneficiary (who is not under a legal disability), then a return is required irrespective of quantum.

We understand that the Commissioner has no power to grant an exemption where there may be tax payable (either by a beneficiary or by a trustee).

However, the ATO have advised that they are investigating alternate ways for this information to be provided rather than through the lodgment of a return, eg: as a bulk lodgment showing beneficiary distributions.

Deceased estates and testamentary trusts

There appears to be conflicting views on whether a deceased estate and a testamentary trust are separate entities for taxation purposes. The separation issue is not a tested position and conflicting views have been illustrated in ATO rulings.

IT 2622 states that the responsibilities of an executor are legally separate and distinct from those of a testamentary trustee.

It also states that for income tax purposes, the estate and the testamentary trust are treated as one and the same.

In terms of capital gains tax, ATO Interpretative Decision 2004/458 states that a testamentary trust is a separate beneficiary of a deceased estate.

However, in Private Ruling 20677, the ATO express a view that when a deceased's assets become subject to a testamentary trust, the assets will continue to be held by the taxpayer's legal personal representative and there is no separation.

Whilst we do not oppose the separation of the deceased estate and testamentary trust from a legal perspective, we believe that in order to achieve administrative efficiencies in tax return preparation, a deceased estate and a testamentary trust should be treated as one and the same under the same tax file number.

We believe that in order to achieve this outcome, there should be a small change in the taxation of such arrangements. The current position has a deceased estate taxed at individual tax rates for the first three years as well as being exempt from Medicare Levy (s251S(1)(c) *ITAA 1936*).

We believe that in combining the deceased estate and testamentary trust for taxation purposes, the concessional tax treatment should continue to be in place for the first three years, then s99 *ITAA 1936* tax rates apply after three years as well as the Medicare Levy exemption to expire after three years.

Conclusion

We feel that the Patch model and the Proportionate within Class model do not meet the stated objectives of minimising compliance costs and complexity.

We believe that the TAD, with modifications based on a risk differentiation approach for deceased estates, testamentary trusts and court order trusts will achieve the stated objectives.

Yours faithfully

Ross Ellis
Executive Director