THE TAX INSTITUTE

15 February 2012

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

Email: trust_rewrite@treasury.gov.au

Dear Sir/Madam

Consultation Paper: Modernising the taxation of trust income – options for reform

The Tax Institute welcomes the opportunity to make this submission on Treasury's Consultation Paper entitled "Modernising the taxation of trust income – options for reform" (the "**Consultation Paper**").

The Tax Institute congratulates the Government on the release of the Consultation Paper and ongoing commitment to the reform of the taxation of trusts. We have long called for reform in this area which our members have repeatedly nominated as creating the greatest compliance difficulties and most in need of legislative clarification.

The Consultation Paper represents a significant first step to streamlining and simplifying the taxation of trusts.

The Tax Institute also welcomes the issue of the Consultation Strategy accompanying the Consultation Paper. The strategy document provides much needed certainty in relation to the timing of changes and is of significant assistance to the taxpayers associated with the 600,000 trusts in Australia.

Our submission below addresses the issues raised in the Consultation Paper by setting out:

- the problems with the current system;
- the high level principles which should, in our view, guide the design and function of any system for the taxation of trusts;
- our observations on the models set out in Chapter 8 of the Consultation Paper; and
- our recommended model for the taxation of trusts.

As a result, our submission does not address all of the questions set out in the Consultation Paper. However, where specific consultation questions are addressed, we have noted the relevant question for ease of reference.

Level 10, 175 Pitt Street
Sydney NSW 2000
Tel: 02 8223 0000
Fax: 02 8223 0077
info@taxinstitute.com.au
taxinstitute.com.au
ABN 45 008 392 372

The comments in our submission are primarily focussed on the taxation of private, family or closely held trusts. However, our comments are equally applicable to public or widely held trusts to the extent that such trusts fall or elect to remain outside the taxation of Managed Investment Trusts regime to be introduced in due course.

Timing of changes and scope of submission

[Questions 2 and 3] The appropriateness of the proposed timeline for the introduction of a new system for the taxation of trusts depends significantly on the extent of the proposed changes.

By way of example we note that if the “Patch model” is chosen, the proposed implementation date of 1 July 2013 appears to us to be achievable and appropriate. In contrast, a wholesale change may require further consultation in order to clarify the details of operation and implementation and a longer time period for such consultation may be appropriate.

We have restricted our comments in this submission to the issues that are in our view most in need of urgent reform or clarification, including:

- Choice of model for reform;
- Time for determining entitlements;
- Character flow-through and streaming;
- Amendments to the scope of section 99B; and
- Amendment period for trustees.

While the many other problems set out in the Consultation Paper (such as for example the treatment of expenses) should in due course be addressed, we recommend that the reform project be undertaken gradually and be aimed at tackling the most fundamental issues (that either relate to or centre on the choice of model) in the first instance. Such an approach will provide much needed certainty and stability to tax agents and taxpayers alike.

We would be pleased to provide a further submission on the remainder of the issues raised in the Consultation Paper in due course.

Problems with the current system

Due to the nature of evolution of the system for the taxation of trusts in Australia, significant complexity has arisen in recent years. This complexity has emerged from various factors which include:

- the interactions between Division 6 of the *Income Tax Assessment Act 1936* (“**Division 6**” of “**ITAA1936**”) and subsequent legislative amendments such as Division 7A of ITAA1936 and the capital gains tax provisions;
- inherent complexities caused by the interaction between tax law and trust law; and
- the growing use of trusts in the past few decades, including in increasing capacities such as for public investment ventures.

This increasing complexity has resulted in a significant compliance burden for taxpayers and tax agents and significant difficulties for the ATO in the course of implementing the relevant laws.
Despite the investment of such significant resources, ongoing litigation and uncertainty continue to dominate the experience of many taxpayers in this arena. Furthermore, the complexity of tax law in this area places significant strain on tax agents in fulfilling their Code of Conduct obligations (as set out in the *Tax Agent Services Act 2009*) to "take reasonable care to ensure that taxation laws are applied correctly to the circumstances in relation to which you are providing advice to a client" and "maintain knowledge and skills relevant to the tax agent services that you provide."

For this reason, the reform of taxation of trusts is among the most important issues facing our members.

The principal difficulties with the current system of taxation of trusts are as follows:

1. *The significant reliance of the current system on trust law to determine the liability for taxation of trust income.* The need to determine "income of the trust estate" in accordance with the trust deed causes significant compliance difficulties owing to both the need to interpret trust law as well as the significant potential variations in trust deeds. The need to draft trust deeds necessarily having regard to tax outcomes also generates significant complexity in that process. In addition, changes to the trust deed (potentially for reasons completely unconnected to tax) can result in unintended tax outcomes.

2. *The 30 June problem.* The need to determine the taxpayers that are presently entitled to the income of the trust estate as at 30 June causes significant compliance difficulties. This is because the income of the trust is unlikely to have been determined by that date (in most cases). This requirement represents reliance on an out-dated concept that bears little relevance to modern commercial practices.

3. *Interaction between Division 6 and other areas of the tax law.* The failure of Division 6 to interact appropriately with tax concepts that have arisen since, such as capital gains tax ("**CGT**") (including the small business entity rules and the application of the CGT discount), and Division 7A of the ITAA1936 (including the tax treatment of unpaid present entitlements under the trust in favour of a private company) as well as those parts of the tax law that give rise to timing differences between trust recognition and tax recognition (such as controlled foreign company and foreign accumulation fund rules, taxation of financial arrangements, Division 16E of the ITAA1936 and Divisions 40 and 43 of the *Income Tax Assessment Act 1997* ("**ITAA1997**")).

4. *Complexity of the new streaming rules (i.e. the June 2011 amendments).* The increased compliance costs caused by the complexity of properly applying and calculating the tax outcomes arising from the application of these amendments.

Desirable features of a system for the taxation of trusts

[Question 1] The Tax Institute agrees in principle with policy principles 3 to 5 (as set out in section 1.2 of the Consultation Paper) underpinning the reform project subject to the caveat that there should not be any suggestion that physical distribution of cash needs to be made.

In addition to those principles, in our view, the desirable features of a trusts taxation system are as follows. The system for the taxation of trusts should:

1. be contained within tax laws and should (to the greatest extent possible) not rely on the operation of trust law;

2. allow determination of tax liability to be made after the end of the income year to which the liability relates and on a basis consistent with the determination of the income of the trust;

3. allow the character of income (as determined after the application of directly related expenses to each type of income and the apportioning of any indirect expenses on a quantum basis) to be retained as income flows-through the trust and is assessed in the hands of beneficiaries. We strongly recommend that the current streaming rules in the ITAA1936 and the ITAA1997 be replaced with a simpler and more effective set of rules. While the current rules were an adequate solution to the problems created by the ATO's withdrawal of TR 95/29 and other ATO guidance following the High Court's decision in the *Bamford* case, these rules are unnecessarily complex and difficult to apply. As such, the rules should be replaced in their entirety (save the anti-avoidance provision – see further below) with a set of rules that is easier to apply; and

4. to the extent that recovery problems need to be addressed, address the issue of liability first then deem entitlement to trust income to allow for recoverability from trustee and beneficiary (where relevant).

However, it is our view that the first two principles set out in section 1.2 (replicated below) ought to either be explained in greater detail or removed/amended.

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.

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.

Tax liabilities should "follow the money"

This first guiding principle, which along with the other principles represents the "broad policy framework currently applying to the taxation of trust income" (according to the Consultation Paper) is in our view not appropriate. This is because under the current Division 6, tax liabilities are not required to "follow the money", in that:

- There is no requirement to distribute cash or property to the beneficiary (whether in line with tax liability or otherwise).

- Tax liability is calculated with reference to a present *entitlement* to income which may but is not required to be called on by the beneficiary.

- As such, retention of taxed profits within the trust is permitted.

Furthermore, such a requirement to ensure that the economic benefit of trust income accords with the tax liability in respect of that income ignores the fundamental disassociation between the notions of economic benefit and tax liability.

We note that tax liability is artificially calculated on the basis of 'taxable income' as defined, which may bear little resemblance to economic benefit. A particular example is the notional

amounts of income included in the trust's net income, in relation to which there is no connection between the economic benefit and tax liability. This is also a problem for all taxpayers who may have present economic accretion to wealth but not the present means to enjoy that accretion.

In addition, "economic benefit" is an uncertain concept that is difficult to define both in and of itself and especially with reference to the 'distribution' of economic benefit. It remains to us exceedingly unclear as to what is meant by either "following" or "money" in the context of this guiding principle.

It is our strong view that any attempt to equate the receipt of economic benefit with tax liability will always be fraught with complications, largely akin to the complications that currently exist in relation to Division 6.

Any system for the taxation of trusts based on this guiding principle will result in undesirably complex tax laws.

Minimising anomalous results and opportunities to manipulate tax liabilities

In order to better inform the consultation process, it would be advantageous to further define what, in Treasury's view constitutes an "anomalous result" or "opportunity to manipulate tax liabilities".

Specifically, it is unclear to us whether in Treasury's view such results and opportunities arise in **all** situations in which the cash or assets from a trust are distributed to one beneficiary while another bears the tax liability, or is limited to situations where the taxpayer bearing the tax liability has preferential tax attributes (e.g. is a tax-exempt entity).

- Should the former be the case, we encourage Treasury to provide further detail on the appropriate tax outcome in such circumstances where there is no economic benefit related to the tax liability i.e. where the tax liability relates to a notional amount of assessable income.

- Should the latter be the case, it would be useful to define what circumstances amount to anomalous results or opportunities to manipulate tax liabilities in Treasury's view.

Suggested alternate guiding principle

It is our view that a more appropriate guiding principle (to replace principles 1 and 2 as set out in section 1.2 of the Consultation Paper) is as follows:

- All taxable income of the trust is (ultimately) included in the assessable income of a taxpayer.

To the extent that the system resulting from this guiding principle creates scope for 'anomalous results' or 'opportunities to manipulate tax liabilities', we recommend that such problems be tackled by way of an anti-avoidance provision. In this regard we recommend that the current anti-avoidance provision in section 100AA of the ITAA1936 be retained but revised to take into account the circumstances created by the new system for the taxation of trusts. In this regard, we recommend that such an anti-avoidance rule be restricted to specifically deal with apportionment of income to tax exempt entities.

Such a principle accords with the key elements of any approach to taxing trust income as set out in section 6.4 of the Consultation Paper and preserves the favourable features of the current Division 6 while simultaneously ensuring that all taxable income of the trust is

included in the assessable income of a beneficiary that is liable to pay tax on their taxable income.

Models proposed in the Consultation Paper

[Question 12] The models proposed in the Consultation Paper each have some merit and address some of the problems set out above. However, in order for any of these models to constitute a simple, fair and efficient system for the taxation of trusts, revisions are necessary in respect of each. Our comments on each of the models are set out below.

The Patch Model

- This model will address problems of interaction between tax law and trust law but will not address any of the other problems set out above.

- Specifically the problems of determining the beneficiaries that are presently entitled to the income of the trust, interactions with other areas of tax law and the 30 June problem would continue to dog the new system.

- The current streaming rules will likely remain in their current form generating ongoing complexity.

- The current problems caused by dealings with notional income will continue to generate ongoing complexity and anomalous outcomes.

- This model is a start at best, and as an entire reform project is a wasted opportunity to tackle the remaining significant issues in this area.

- If this model is adopted, we recommend consideration of the appropriateness of the current tax rate for income taxed in the hands of the trustee. Please see the section entitled "Taxing the trustee" below.

Proportionate within class model

- This model will allow for retention of character of income and streaming of particular types of income.

- However, the model does not address problems of interaction between tax law and trust law and will also not address many of the other problems set out above [Question 13].
- Problems related to the interaction of the current system with other areas of the tax law would continue to exist.

- The model will (for the most part) represent an improvement on the current system but nevertheless represent a wasted opportunity for significant reform.

- If this model is adopted, we recommend consideration of the appropriateness of the current tax rate for income taxed in the hands of the trustee. Please see the section entitled "Taxing the trustee" below.

The trustee assessment and deduction (TAD) model

- This model resolves a number of issues related to the interaction of trust law and tax law, the need to determine present entitlement by 30 June and will allow for character retention and streaming through the trust.

- However, this model (in the form set out in the Consultation Paper) will cause ongoing problems and remove many of the current and desirable features of Division 6. Most especially, our concerns include:

    - The manner in which "deductions" to the trustee will be determined. It is unclear to us what would constitute a "distribution" to beneficiaries especially in the context of notional amounts of assessable income which may not be represented by underlying assets or cash within the trust. In our view, should this model be adopted, an entitlement to an amount of income should be sufficient to have made a 'distribution' i.e. actual payment of cash or transfer of property should not be necessary.

    - As the model is described in the Consultation Paper, it appears as though all notional amounts that cannot be so "distributed" via an "actual payment or an application of cash or property" will be taxed in the hands of the trustee. As a result, we have concerns about the rate at which such amounts will be taxed in the trustee's hands. If the applicable rate is the top individual marginal tax rate (as is currently the case in respect of trust income taxed in the trustee's hands), such notional amounts are likely to be taxed at a significantly higher rate than would have been the case had the amounts been taxed in the hands of the beneficiaries under the current Division 6.

    - Requiring cash or property to be distributed from the trust may cause cash flow difficulties or a depletion of the assets of the trust. Hence the adoption of this model will take away the currently available feature of retaining income that has been taxed in an individual beneficiary's hands within the trust.

    - If this model is adopted, we recommend consideration of the appropriateness of the current tax rate for income taxed in the hands of the trustee. Please see the section entitled "Taxing the trustee" below [Question 14].

    - If the rate at which the trustee is liable to be taxed is lower than the top individual marginal tax rate, will an integrity mechanism (such as Division 7A for companies) need to be introduced in respect of trusts?

Taxing the trustee

In order to alleviate problems associated with the tax treatment of unpaid present entitlements (UPEs) in favour of private companies, any system for the taxation of trusts should allow for trust income that is taxed in the trustee's hands to be taxed at a rate that approximates the ultimate tax liability resulting from the conversion of the UPE to a loan with interest levied at the Division 7A benchmark rate.

In addition, consideration should be given to whether this taxation rate should represent a final tax liability borne by the trust or whether a credit mechanism (i.e. where the credits associated with the tax paid could be attached to trust distributions and constitute an offset in the hands of the beneficiary) is appropriate. Such a credit mechanism could be either elective (at the discretion of the trustee) or compulsory. A credit mechanism would provide a more accurate effective tax rate since the distribution would ultimately be taxed at the beneficiary's marginal tax rate.

The character of income should be retained on distribution and trustees should be able to stream different types of income to particular beneficiaries.

Though the applicable rate of taxation will likely be lower than the top marginal tax rate, we do not recommend the introduction of an integrity mechanism (akin to Division 7A) for trusts. This is because:

- the applicable rate is likely to only create scope for lower taxation via retention for taxpayers at the top individual marginal tax rate; and
- the potential for abuse or loss of revenue (as a result of not implementing an integrity mechanism) is so low that the complexity that would result from such a mechanism is unwarranted.

Conceptual model

In order to overcome the difficulties associated with each of the models proposed in the Consultation Paper and preserve the desirable features of the current Division 6, we recommend consideration of the following model:

- The taxable income of the trust is calculated with reference to the current section 95, ITAA1936. Direct expenses should be applied against each type of income and all indirect expenses should be apportioned across the types of income on a quantum basis.
- The trustee may enter into an agreement with each beneficiary in relation to the amount and specific type of taxable income of the trust for which that beneficiary will be liable (by which we mean that the trustee and beneficiary may agree to stream the income).
- Such an agreement may be akin to a tax sharing agreement or to the administrative treatment that was previously allowable under the now-withdrawn PS LA 2005/1 in relation to the taxation of capital gains of a trust.
- Under such an agreement, the effect of any amendments (to either increase or decrease the taxable income of the trust) will be allocated as agreed, or if there is no agreement on a proportionate basis among the beneficiaries unless the agreement between the trustee and beneficiary specifically provides for the beneficiary to be taxed on all of a particular class of income or capital gain.
- In the context of private, family or closely held trusts such an agreement need not be made in writing, but may be evidenced by the inclusion of the relevant amount of the trust's taxable income in each beneficiary's income tax return in respect of the relevant income year.
- In the context of a public or widely held trust, an agreement will need to be made in writing to transfer the tax liability from trustee to beneficiary even if the beneficiary does not include the amount in his/her tax return in relation to that year. That agreement may be found in the Trust Deed or in the Product Disclosure Statement accompanying the investment offer.
- As above, in the context of private, family or closely held trusts the agreement may be made and evidenced by either the tax return or any amendment to the tax return of a beneficiary on or before 30 June of the following income year (the true-up date).
- After the true-up date, any income which is not the subject of such an agreement will be taxed in the hands of the trustee. As noted above, we recommend that the

rate at which the trustee is taxed on this income be approximately the rate at which the income would be taxed had it represented a UPE in favour of a company.

- If the trustee does not include such an amount in its assessable income, the ATO may amend the trustee's income tax return after the true-up date to include the relevant amounts of trust income in the trustee's income tax return.

- The lapse of time between the end of the income year to which the tax liability relates and the true-up date (i.e. one year) will alleviate current problems caused by the need to determine present entitlement by 30 June and allow taxpayers, trustees and tax agents a period of time in which to determine the taxable income of the trust and lodge each beneficiary's tax return. In addition, the creation of a final date by which beneficiaries must include trust income in their assessable income (in order to prevent the trustee being taxed on the income) will likely increase timely lodgment of income tax returns. Notably, such a provision should not result in changes to the lodgment date of the beneficiary or trustee.

- In order to address problems of recoverability by the ATO, where a beneficiary has agreed or is taken to have agreed to bear the tax liability in respect of an amount of trust income, the beneficiary should be deemed to have an entitlement to that trust income as against the trustee. Such a deeming should largely resolve issues where a beneficiary does not meet his/her own tax liability as the ATO will in such circumstances have recourse to the trustee.

- However the ATO should not be able to recover the tax liability in respect of such trust income from a beneficiary who has not agreed to bear the tax liability, as any such rule would inappropriately hold one beneficiary to account for the actions of another.

Clarifying the scope of section 99B

As noted in the Consultation Paper, the potential scope of operation of section 99B is far wider than intended, so that section 99B of the ITAA1936 as currently constructed is capable of applying in respect of Australian sourced as well as foreign sourced income. We recommend that in order to provide much needed certainty in relation to the operation of this section, section 99B be revised to clarify that it only applies in respect of foreign sourced income (as originally intended).

Clarifying the scope of Division 6

In response to the discussion at sections 3.1 and 7.1 of the Consultation Paper, in our view the taxation of bare trusts should not be subject to Division 6. Specifically, we consider that bare trusts should be ignored (i.e. looked through) for income tax and GST purposes. In addition, we recommend that the definition of the term "absolutely entitled" in the capital gains tax provisions be clarified for this purpose.

The restriction of the scope of operation of the taxation of trusts regime is essential to correct the uncertainty caused in this regard as a result of the ATO's interpretation of the scope of Division 6.

Family trust and losses rules

In response to sections 5.2 and 5.3 of the Consultation Paper in relation to the trust loss rules and family trust rules, we note that these measures are complex and difficult to apply and lead to (sometimes significant) compliance costs. This view is consistent with the

Board of Taxation's observations as noted in paragraph 21 of the Board's report on the "Taxation of Discretionary Trusts" (November 2002).

Furthermore we understand that the operation of these rules has not been subject to formal review since their introduction in 1998. As such, we consider it timely for the Government to commission a review of these provisions with the intention of simplifying and streamlining their operation. It may be appropriate to involve the Board of Taxation in such a review process.

Amendment period for trustees

We recommend that the law be amended to limit the amendment period in respect of trustees who have not received an assessment. This change will provide much needed certainty for trustees in relation to tax affairs of the trust and is in our view long overdue.

This view is consistent with the comments in our submission to Treasury in response to the August 2007 Discussion Paper entitled "Review of Unlimited Amendment Periods in the Income Tax Laws".

* * * *

Should you have any queries with respect to any of the matters raised above, please do not hesitate to contact me on (02) 8223 0011 or the Tax Institute's Tax Counsel, Deepti Paton on (02) 8223 0044.

Yours sincerely

Ken Schurgott
President