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A WHK Group Firm

10 February 2012
The General Manager
Business Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

Sent via email: trust_rewrite@treasury.gov.au

Dear Sir/Madam

**RE: CONSULTATION PAPER – MODERNISING THE TAXATION OF TRUST INCOME –
OPTIONS FOR REFORM**

We welcome the opportunity to comment on the Consultation Paper *Modernising the taxation of trust income – options for reform*. As noted in the introduction to the consultation paper, it is clear that this is a long overdue reform of the taxation system in Australia and one that will equip Australia for the challenges associated with moving into the middle part of twenty first century.

Crowe Horwath and the WHK group are the fifth largest accounting and advisory firm in Australia. Whilst we provide all types of tax advice, the great majority of our national firm's client profile involves Small and Medium Enterprises (SME) many of whom run their businesses through trust structures or have a trust (other than a superannuation fund) in the corporate group. Acting for more than 16,000 trusts, we believe that we uniquely positioned to articulate many of the concerns of our client base.

We act for trusts that are used for business and investment purposes, for deceased estates and testamentary trusts, trusts that are involved in primary production and agricultural activities, widely held trusts that act as investment vehicles and international trusts. As such, our submission includes commentary on many of the issues that directly affects these clients.

If you have any queries or require any further information please contact Tristan Webb on (02) 9367 3035

Yours sincerely
WHK GROUP PTY LTD

TRISTAN WEBB
WHK/Crowe Horwath National Tax Director



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APPENDIX A: COMMENTS ON THE CONSULTATION PAPER

1. OVERVIEW

This submission provides comment on the trust consultation paper, in particular the following areas:

- Legislative design
- The definition of income and treatment of expenses
- Character flow through
- Administrative issues associated with the taxation of trust income
- Interaction between Division 6 of the ITAA 1936 and other areas of the Income Tax Assessment Act
- International issues
- Our recommendations

The recommendations herein are based on the principle that reforms to our tax system should seek to achieve greater equity, efficiency and simplicity. Primarily we believe that in reforming the taxation of trusts, the government should seek greater simplicity and reduced costs of administration and compliance.

Accordingly our recommendations in response to the Consultation Paper are:

Recommendation 1 – *We believe it is appropriate to design legislation that taxes trust arrangements subject to the purpose for which the trust was created. The most appropriate system would recognise the different categories of trust and treat them accordingly. Each type of trust should have its own stand-alone provisions.*

Recommendation 2 – *Any new trust taxing provision should be simple, coherent and straightforward. Moreover, it should strive to provide taxpayers with a clear definition of what is to be taxed and certainty as to the amount of tax which should be paid on each taxable object. This should be achievable with regard to the economic substance of the arrangement and not the legal form as characterised by the trust deed.*

Recommendation 3 - *As a basic principle, the tax law should allow a receipt that is classed as income for tax purposes to be distributed by the trustee and assessed to the beneficiary of the trust in all cases.*

Recommendation 4 - *The government should consider defining “distributable income” of trusts while “net income” retains the tax definition. The government should legislate a “second s97” for capital gains only.*

Recommendation 5 – *The ATO should be directed to issue an administrative statement whereby trusts are able to amend the income clause in the trust to align with the definition of “distributive income” without causing a trust resettlement.*

Recommendation 6 – *For trusts that may have to maintain their current income clause they should be able to provide (1) a distribution for tax purposes; and (2) a separate distribution for trust law purposes.*

Recommendation 7 – *The government should give consideration to inserting expense rules in calculating distributable income. Broadly, the rule should be drafted with the following principles in mind:*

- *All economic rather than tax liabilities should be recognised*
- *For depreciable property, the rate of deduction should equate to the tax rate of depreciation*

Recommendation 8 – *The government should give consideration to a complete flow through model for the taxation of trust income.*

Recommendation 9 – *Legislate to allow the timing of present entitlement to be established by the date of lodgement of the trust tax return or a statutory date in the calendar year following the end of the financial year in which the entitlement is created.*

Recommendation 10 – *That the committee review Division 7A of the ITAA1936 as it applies to trusts, and in particular Unpaid Present Entitlements and Subdivision EA.*

Recommendation 11 – *That the committee review the interaction of Division 43 of ITAA97 and CGT E4 to eliminate the possibility of double taxation.*

Recommendation 12 – *That the committee review s 99B and 99C with a view to providing more detail about the application of these provisions and their intent.*

2. TAX REFORM THEORY

The traditional criteria for appraising the efficacy of a tax system have been broadly categorised as equity, efficiency and simplicity. In the modern era these criteria have been further refined as follows:

1. Incentives and economic efficiency
2. Distributional effects
3. International aspects
4. Simplicity and the cost of administration and compliance
5. Flexibility, stability and certainty
6. Transitional problems¹

We acknowledge that there has been a shift away from this sort of thinking in first part of the 21st century. The policy prescriptions that flow from this traditional tax theory tend to veer toward low tax rates and a broad tax base. However, policy makers have realised that broad based taxes do not necessarily minimise distortions and the low rate prescription can lead to a greater degree of inequality².

Policy makers are moving toward more strategic thinking in tax design. This has led to the adoption of what is sometimes referred to as “optimal tax theory”. This methodology attempts to set out the cost in terms of lost efficiency from a tax measure using empirical data and econometric modelling³.

As an accounting and advisory firm, Crowe Horwath/WHK is not in a position to contribute to optimal tax theory policy prescriptions. However, we believe that Meade’s criteria listed above should continue to inform the debate to some extent. Moreover, we believe that in reforming the taxation of trusts, the government should emphasise satisfaction of criterion 4 - simplicity and the cost of administration and compliance. As documented in this submission, other issues such as certainty and international aspects should also be born in mind.

Whilst we applaud the Assistant Treasurer’s decision, in March of 2011 to implement an interim measure post the High Court’s decision in *Bamford’s*⁴ case to allow the “streaming” of certain classes of income, the legislation as currently enacted only adds to the confusion surrounding Division 6 of the Income Tax Assessment Act 1936 (“ITAA 1936”) and must be changed as soon as possible.

The current Division 6 of the ITAA1936 (“Division 6”) does allow for the “streaming” of capital gains and franked dividends, however it also produces some absurd results. For instance, it is now possible for beneficiaries to be taxed on capital gains that they do not even receive – an issue that the ATO attempted to redress in the now withdrawn practice statement PS LA 2005/1 (GA). This means that in some cases, taxpayers will now be worse off than they were when the Tax Office released this practice statement back in 2005.

¹ Meade M *The structure and reform of direct taxation* (London: Allen and Unwin, 1978), p7.

² Cooper G A *Toe in the Water – Henry and the Tax Forum* (Tax Institute of Australia, Western Australia Division, 11-12 August 2011).

³ *Ibid*, p11.

⁴ *Commissioner of Taxation v Bamford; Bamford v Commissioner of Taxation* [2010] HCA 10 at 17.

3. LEGISLATIVE DESIGN: PRACTICAL LEGISLATION FOR TRUST TAXPAYERS

Recommendation 1 – *We believe it is appropriate to design legislation that taxes trust arrangements subject to the purpose for which the trust was created. The most appropriate system would recognise the different categories of trust and treat them accordingly. Each type of trust should have its own stand-alone provisions.*

The consultation paper provides two options for the design of the new tax rules. One is a single taxing provision that applies to all types of trust (“one size fits all”), the other recognises different types of trust and treats each type in different ways (“characterise then tax method”).

We favour the latter method (“characterise then tax method”).

Given that in 21st century Australia, trusts are used for many different purposes, we do not think it is appropriate that a single taxing provision applies to all trusts. Of the 660,000 trusts currently in operation in Australia⁵, most would fall into one of the following categories:

- Family trusts used for investment purposes
- Family trusts that carry on a business
- Deceased estates and testamentary trusts
- Special purpose and charitable trusts
- Employment benefit trusts
- Large scale investment vehicles

From a legal perspective, most or all of these vehicles is a “trust”, but in many cases that is where the similarity ends. It is time to design legislation that looks beyond the legal form of an arrangement, and taxes the arrangement subject to the purpose for which the trust was created. In our view, having one provision that taxes each of these arrangements in the same manner may lead to sub-optimal outcomes.

The most appropriate system would recognise the different categories of trust and treat them accordingly. The United Kingdom’s system of demarcating between non-discretionary and discretionary/accumulation trusts could be borrowed and extended in Australia. We envisage a new Division being inserted in the ITAA 1997 with subdivisions that are applicable to each of the above type of trust.

Whilst we agree with the discussion paper that, where possible, taxing provisions should be “robust to variety”, in reality this will be difficult to attain with a single taxing provision. After all the current Division 6, whether by accident or design, generally applies “to all categories of trusts and, because of the extended definition of trustee (in section 6), may also apply to arrangements that are not trust arrangements under trust law (for example, deceased estates)”⁶.

⁵ Assistant Treasurer, Press Release No. 155 of 2011, 21 November 2011.

⁶ The Australian Government the Treasury, *Modernising the taxation of trust income – options for reform*, p 9, November 2011.

Over 20 years ago, Hill J pointed out in *Davis v Federal Commissioner of Taxation*⁷ that ‘it is quite clear that neither interpretation of section 97 (quantum or proportionate) produces a desirable result as a matter of tax policy and the scheme of Division 6 calls out for legislative clarification, especially since the insertion into the Act of provisions taxing capital gains as assessable income’.

Whilst many commentators have used this as a clarion call for reform of Division 6, it also points to the problems of using a “central gateway” provision and applying it to all trusts. The current Division 6 and in particular section 97 (with various amendments) have been in operation for decades and there were obviously times when the precise wording of this provision produced appropriate tax results. However, it is clear now that this will not always be the case and recent amendments introducing Div 6E only further muddy the waters with the only benefit being the ability to “stream” two particular classes of income.

4. THE DEFINITION OF INCOME AND THE TREATMENT OF EXPENSES

Recommendation 2 – *Any new trust taxing provision should be simple, coherent and straightforward. Moreover, it should strive to provide taxpayers with a clear definition of what is to be taxed and certainty as to the amount of tax which should be paid on each taxable object. This should be achievable with regard to the economic substance of the arrangement and not the legal form as characterised by the trust deed.*

Recommendation 3 - *As a basic principle, the tax law should allow a receipt that is classed as income for tax purposes to be distributed by the trustee and assessed to the beneficiary of the trust in all cases.*

Recommendation 4 - *The government should consider defining “distributable income” of trusts while “net income” retains the tax definition. The government should legislate a “second s97” for capital gains only.*

Recommendation 5 – *The ATO should be directed to issue an administrative statement whereby trusts are able to amend the income clause in the trust to align with the definition of “distributive income” without causing a trust resettlement.*

Recommendation 6 – *For trusts that may have to maintain their current income clause they should be able to provide (1) a distribution for tax purposes; and (2) a separate distribution for trust law purposes.*

Recommendation 7 – *The government should give consideration to inserting expense rules in calculating distributable income. Broadly, the rule should be drafted with the following principles in mind:*

- *All economic rather than tax liabilities should be recognised*
 - *For depreciable property, the rate of deduction should equate to the tax rate of depreciation*
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⁷ (1989) 86 ALR 195 at 230.

Bamford's case informs us that income of the trust estate is to be determined by reference to general trust law principles and the trust instrument. Notional amounts such as imputation credits remain steeped in mystery – with apparently conflicting results at the highest levels in litigation. The recent decision in *Colonial First State Investments Ltd v Commissioner of Taxation*⁸ suggests that imputation credits should not be considered trust income whereas the decision in *Thomas Nominees v Thomas & Anor*⁹ reached exactly the opposite conclusion.

Capital items

Bamford supports the ability to treat capital receipts as income if this is provided for under the trust instrument. Many trusts that may have been established in previous decades may very rarely crystallise capital gains. It is somewhat inconceivable that in the twenty first century, if the trust does not have an appropriately wide income clause or a reclassification clause, the trustee can appropriately distribute the capital gain for trust purposes and yet for tax purposes it is assessed to someone else or even the trustee.

This is surely a triumph of legal form over economic substance. An appropriate regime for the taxation of trusts should be coherent, simple and straight forward. If beneficiary X receives a \$Y distribution from a trustee, beneficiary X should be assessed on \$Y. If the distribution contains some amounts that are non-taxable in the beneficiary's hands, then assessing the beneficiary to a proportionate percentage of the distribution may well be appropriate, however it should not be dependent on the trust deed. It should not be a requirement that taxpayers with trusts are required to obtain legal advice just to ensure compliance with the tax laws.

The emphasis that *Bamford* and other case law¹⁰ has placed on the trust deed has moved Division 6 away from some of the principles of good tax design. Any new trust taxing provision should be simple, coherent and straightforward. Moreover, it should strive to provide taxpayers with a clear definition of *what* is to be taxed and certainty as to *the amount* of tax which should be paid on each taxable object. This should be achievable with regard to the economic substance of the arrangement and not the legal form as characterised by the trust deed.

As a basic principle, the tax law should allow a receipt that is classed as income for tax purposes to be distributed by the trustee and assessed to the beneficiary of the trust. Given that s 97 was drafted before the advent of the capital gains tax legislation, this was surely the intent of the drafters. To have capital receipts, that for all other taxpayers are part of their income, “stuck” at trustee level or assessed to beneficiaries in proportion to their receipt of other income is unreasonable – particularly when the sole determinant of this outcome is the absence of a particular clause in the deed.

A simple solution to this problem involves the following:

- An amended equivalent of s97 in the new provisions
- A definition of distributable income

⁸ *Colonial First State Investments v Commissioner of Taxation* [2011] FCA 16

⁹ *Thomas Nominees Pty Ltd ACN 010 049 788 v Thomas & Anor* [2010] QSC 417, Supreme Court of Qld, Applegarth J, 11 November 2010

¹⁰ For instance, *Ibid* and *Cajkusic v Commissioner of Taxation* [2006] FCAFC 164

In the re-write a new provision could be inserted that would parallel s97 with some crucial adjustments. Basically this provision could be expressed in similar terms to s97 however “income of the trust estate” would be a defined term (see below). A separate subsection could also be inserted for capital gains. In this subsection (“the subsection”) “net income” would need to be replaced by “capital gains tax amount” and any capital gains would flow out of the equivalent of s97(1)(a) and into the subsection.

Defining a trust’s distributable income

Given the April 2011 decision to defer¹¹ consideration of the proposal to better align the concept of “income of the trust estate” with “net income of the trust estate”, it is our view that “alignment” of these two concepts is not possible. On this basis the government should consider defining “distributable income” of trusts while “net income” retains the tax definition.

We see no reason why it should not be possible to adopt a broad definition of income along the lines of the one associated with American economist Henry Simons¹². Broadly, this definition states that income consists of the sum of the economic gains a person has experienced during the relevant period. This definition could include anything of value including all tax fictions such as imputation credits and may operate independently of the trust deed.

While this creates an additional “tax fiction”, it means that many of the problems surrounding trust deeds will disappear because, for tax purposes it will be irrelevant how the trust deed defines income. “Distributable income” would then accurately reflect the economic position of the trust. The trustee could then distribute this amount for tax purposes, and the beneficiaries would be assessed on their proportion of the distributable income as applied to the “net income” of the trust.

Given that it is now government policy to allow the streaming of capital gains and franked distributions, in order to satisfy the good tax policy criteria outlined above there should be no reason why this is not extended across all the (tax) classes of income. Accordingly, all income that is classified for tax purposes such as Interest, Royalties, Foreign, and Primary Production (etc.) should be able to be characterised by the trustee and “streamed” to particular beneficiaries.

Of course, in many cases there will be some “distributable income” that is not taxable – for instance exempt income. If this is able to be separately identified, our preference is for this to be allowed to be identified and “streamed”. If this is not possible, owing to government revenue constraints, then this may need to be distributed among beneficiaries according to their share (proportion) of the other distributable income (similar to the current Div 6).

Given that there are over 660,000 trust taxpayers in the Australian tax system, there are likely to be thousands of different types of income clauses (even though many purport to do

¹¹ Assistant Treasurer's address to the Institute of Chartered Accountants 2011 *National Tax Conference* 6 April 2011

¹² Henry C. Simons, *Personal Income Taxation: The definition of income as a problem of fiscal policy* 50 (1938).

the same thing) across this group. Some of these may feel disadvantaged by these changes. In order to alleviate this:

- The ATO should be directed to issue an administrative statement whereby trusts are able to amend the income clause in the trust to align with the definition of “distributive income” without causing a resettlement
- For trusts that may have to maintain their current income clause they should be able to provide (1) a distribution for tax purposes; and (2) a separate distribution for trust law purposes

The treatment of expenses

Although former s50 merely provided ordering rules for applying deductions against particular classes of assessable income, its repeal has added to the uncertainty surrounding the taxation of trust income.

As net income is a statutorily defined term, there does not appear to be any urgency in replacing s50, however the government should give consideration to inserting expense rules in calculating distributable income if it were to pursue this option. Broadly, the rule should be drafted with the following principles in mind

- Similar to the definition of income, all economic liabilities should be recognised
- For depreciable property, the rate of deduction should equate to the tax rate of depreciation

This should ensure that there are very few cases where net income is less than distributable income.

The main occasion in which net income is less than distributable income will be when the trustee crystallises either a pre-CGT capital gain or a discount capital gain. In this case, again, the government should give consideration to allowing the trustee to do a separate distribution of this amount. Again, if this is not possible due to revenue considerations then this may need to be distributed among beneficiaries according to their proportion of the other distributable income (similar to the current Div 6). If there is no other distributable income, the capital gain should be able to be distributed regardless of how the deed defines income.

5. CHARACTER FLOW THROUGH AND STREAMING.

Recommendation 8 – *The government should give consideration to a complete flow through model for the taxation of trust income.*

The ATO issued a Decision Impact Statement immediately after the *Bamford* case, in that Decision Impact Statement the Commissioner stated that the High Court judgment does not support the view that amounts distributed by trustees always retain the same character in the hands of the beneficiaries for trust and tax law purposes as they had in the hands of the trustees for those purposes.

Without reprinting the relevant passages, we disagree with the Commissioner.

In any case, the debate has moved on. As the Assistant Treasurer noted in his speech to the Tax Institute of Australia “Before the *Bamford* case, trusts commonly streamed income to particular beneficiaries and the Government wants to ensure that this flexibility can continue.”¹³

While streaming is not the same thing as character flow through or “conduit theory”, it is a precursor to it – streaming relies on conduit theory. On this basis, the government clearly supports conduit theory and we would also like to see it enshrined in any re-write of Division 6.

The government should give consideration to a complete flow through model for the taxation of trust income. Under one variant of this model each tax class of income flows through to beneficiaries as though they had derived that income. Expenses incurred by the trustee that are directly related to that income are applied against the income. Where one tax class of income is provided to more than one individual, expenses that relate to that income are utilised by beneficiaries on a proportionate basis. Tax concessions and tax preferences attach to classes of income and cannot be distributed other than to beneficiaries in proportion to their receipt of that class of income. (For example, an individual that received the assessable part of a capital gain would also be required to receive the discount).

As a matter of principle, we would support moving the taxation of trusts to align with this doctrine.

¹³ Assistant Treasurer, Speech to the 26th National Convention, *Tax Institute of Australia*, 4 March 2011

6. ADMINISTRATIVE ISSUES ASSOCIATED WITH THE TAXATION OF TRUST INCOME

Recommendation 9 – *Legislate to allow the timing of present entitlement to be established by the date of lodgement of the trust tax return or a statutory date in the calendar year following the end of the financial year in which the entitlement is created.*

It is common ground amongst both Treasury and many tax practitioners that the great majority of trust accounts are not drawn up by the end of financial year. In fact, as a matter of physical practicality it is almost impossible to manage by 30 June. The Tax Agents lodgement program recognises the reality that many taxpayers take some time after year's end in order to obtain all the information necessary to file a tax return.

In the case of trustees making beneficiaries presently entitled to income, under the tax law this is required to be established by 30 June. This belies the reality. We do not see what the mischief is in allowing all relevant financial information to be obtained, the trust accounts to be properly constructed, and then the trustee creates present (or specific) entitlement under the deed. Ideally, this requirement would need to be obtained by the date of lodgement of the trust tax return or a statutory date in the calendar year following the end of the financial year in which the entitlement is created.

It is recognised that many trust deeds have a clause that requires present entitlement to be established on 30 June. However, there is no trust law requirement that present entitlement be established on 30 June unless required to do so by the deed. So it seems that many deeds that have a clause that provides for compulsory present entitlement on 30 June have these clauses for tax purposes. The requirement to establish present entitlement by 30 June creates other practical issues – for instance, why shouldn't trustees have the ability to flow fixed dollar amounts through to beneficiaries rather than minuting proportions because they are not sure what the dollar amount actually is?

Similar to our recommendation in relation to income clauses, we suggest if the government were to adopt this recommendation, consideration should be given to allowing trustees to amend deeds to adjust the compulsory present entitlement clause without triggering a resettlement.

7. INTERACTION BETWEEN DIVISION 6 AND OTHER AREAS OF THE INCOME TAX ASSESSMENT ACT

Recommendation 10 – That the committee review Division 7A of the ITAA1936 as it applies to trusts, and in particular Unpaid Present Entitlements and Subdivision EA.

Recommendation 11 – That the committee review the interaction of Division 43 of ITAA97 and CGT E4 to eliminate the possibility of double taxation.

Ensuring a seamless transition between the trust taxing provisions and the other provisions of the tax law are essential in ensuring a robust trust taxing regime. Therefore, the interaction between Div 6 and some of the other key areas of the tax law including the imputation rules, CGT (including resettlements), withholding tax provisions, Division 7A, trust loss and the consolidations provisions should also be considered.

However, we would like to focus of two specific areas:

- Division 7A
- CGT – in particular CGT event E4

Division 7A

The lack of legislative clarity in relation to the relationship between the trust taxing provisions and Division 7A has resulted in what we consider to be administrative overreach by the ATO. Taxation Ruling TR 2010/3 was finalised on 2 June 2010 and contains the Commissioner's view on when a private company with an unpaid present entitlement (“UPE”) from a trust makes a loan back to the trust and creates a potential deemed dividend for the purposes of Div 7A of ITAA1936.

While we acknowledge that Div 7A is an integrity measure designed to ensure that private companies cannot make tax-free distributions of profits to shareholders *or shareholders associates* in the form of payments, loans and debts forgiven, we are not convinced that the legislature intended it to apply if:

- The UPE funds are maintained at entity level
- The funds were used for genuine business purposes

We would welcome exploration of this issue by the committee and clear legislation that indicates the intended outcome, rather than the current arrangement in which taxpayers are subject to an ATO interpretation that many commentators argue is not legally well supported.

CGT

Smaller “mum and dad” investors often enter into property trust arrangements and receive “tax preferred” distributions that usually relate to Division 43 of ITAA97 (building allowance). Of course, they do not declare these amounts (as they are not required to) and may receive these sorts of distributions over a number of years. When the trust is wound up the building is sold and the units are redeemed.

The mum and dad investors at this time are quite often unaware that CGT Event E4 has been operating to reduce the cost base of their units in the unit trust and at the same time the cost base of the building is reduced as a result of the building allowance.

The way that these provisions operate should be examined with a view to repealing at least one of the above imposts. As it currently operates, the interaction of these two provisions is grossly unfair because:

- It results in double taxation
- Often those that are subject to both imposts are unsophisticated “mum and dad” investors

8. INTERNATIONAL ISSUES

Recommendation 12 – *That the committee review s 99B and 99C with a view to providing more detail about the application of these provisions and their intent.*

As pointed out in the consultation paper, a 1969 High Court judgment provided that in calculating the distributable income of a trust only Australian source income could be taken into account. This meant that foreign source income could be accumulated by Australian residents in a non-resident trust without liability for Australian tax unless and until the trust income was distributed to a resident beneficiary.

This led to the enactment of s 99B and 99C. However, the provisions themselves lack detail and are uncertain in their application owing to a lack of common law litigation in this area. When double tax agreements are taken into account, the practical reality is that most taxpayers are required to obtain costly third party advice when there is a possibility that these provisions may apply to their affairs. As such we support a review of these provisions with a view to providing more detail about their application and the intent of the legislature in enacting them.