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Ref: AMK

29 April 2011

Mr Haydn Daw
Business Tax Division
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CANBERRA ACT 2600

Email: SBTR@treasury.gov.au

Dear Haydn

EXPOSURE DRAFT - IMPROVING THE TAXATION OF TRUST INCOME

We welcome the opportunity to provide comments on the Exposure Draft issued by the Treasury on improving the taxation of trust income (“the Exposure Draft”).

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

In making this submission therefore, we have focussed on the implications of the Exposure Draft for the middle market.

GENERAL COMMENTS

1. We are supportive of the measures outlined in the Exposure Draft to allow the steaming of capital gains and dividends to beneficiaries. While the mechanics are complicated and could have been done in alternative ways, we believe that (subject to our comments in this submission) these interim measures will achieve the objectives outlined by the Assistant Treasurer in his press release dated 4 March 2011.
2. Our main concern with the Exposure Draft is the stringent requirements relating to the creation of a “specific entitlement” to a capital gain in order to stream the

capital gain. In many cases (if not the majority of cases), we do not believe that a trustee will be able to satisfy the proposed requirements. We highlight that the codification of this requirement is not consistent with the ATO's administrative practice of the past six years – which is contained in paragraphs 8 and 9 of PSLA 2005/1 (GA).

3. For these provisions to work appropriately, and for these provisions to be properly administered by the 660,000 discretionary trusts for the 30 June 2011 income year, we believe it is critical for the Treasury to address this issue. We believe that the provisions will fall short of the Assistant Treasurer's stated objective if this issue is not addressed. We have provided our detailed comments and recommendations to correct this issue later in this submission.
4. There are a number of additional issues that we believe Treasury should consider in finalising the Exposure Draft. These include: drafting an ordering provision to make it clear how Division 5B operates; providing clarity in respect of issues relating to the rateable allocation of expenses; providing certainty on trust to trust streaming; and the introduction of a Commissioner's discretion.

SPECIFIC COMMENTS

Specific entitlement to capital gains

5. As currently drafted section 115-228 proposes a very stringent test that would need to be satisfied before a capital gain can be streamed to a beneficiary. That is, the provision requires: (i) a vested and indefeasible interest to be created (by year end); and (ii) that interest to be in the actual trust property representing the capital gain.
6. The following paragraphs outline our concerns with this test and our suggested solutions that we believe need to be considered by Treasury.

Specific allocation

7. At paragraph 1.53, the Explanatory Memorandum effectively states that the test contained in section 115-228 is not as stringent as the "present entitlement" test contained in Division 6. However, we are not sure that this is correct.
8. Under Division 6, a present entitlement only needs to be created in respect of the income of the trust. Section 115-228 requires a vested and indefeasible interest in the actual trust property giving rise (or representing) the capital gain.
9. We are concerned that it may be difficult to satisfy the section 115-228 test if, for example, a trust derives a capital gain yet reinvests the cash amount in another asset before year end. While other property of equivalent value (for example, cash) may be available for a capital distribution, the "trust property" distributed may not represent the capital gain that was derived (i.e. the trust property representing the capital gain has been reinvested in another asset).

10. We also have significant concerns that a vested and indefeasible interest may not be created in a capital gain that is subject of a straddle contract (discussed below).
11. To address these issues, we believe that section 115-228 should be amended to be consistent with the language in section 207-58 (i.e. to merely require a specific allocation of the capital gain). We believe that this amendment would ensure that both section 115-228 and 207-58 operate utilising the same test (i.e. a specific allocation test) and thus will to ensure a consistency amongst the streaming provisions.
12. Furthermore, we believe that this amendment would be in line with the ATO's practice contained in PSLA 2005/1 (GA), paragraph 8 and 9, which provided the trustee the ability to specifically allocate a capital gain (in addition to creating a vested and indefeasible interest). We note that this practice statement was administered in this fashion by the ATO for more than six years.
13. We note that additional flexibility was provided to taxpayers in that practice statement to appropriately address concerns with the vested and indefeasible test. We are concerned that these issues will re-surface if Treasury does not appropriately modify the rule contained in section 115-228.

Present entitlement to a capital gain

14. In addition to the change above, we believe that section 115-228 should at least include a new test that would satisfy paragraph (a) of that section where the beneficiary is presently entitled to an amount of trust property that corresponds to the capital gain that has been derived.
15. This test could be inserted as a subparagraph under paragraph (a) (i.e. subparagraph 152-228(a)(i)).
16. For example, if the trustee were to derive a \$100 accounting gain, being income of the trust that represented a capital gain of (say) \$90 derived by the trustee during the year, the creation of the present entitlement to the \$100 would satisfy the requirements of paragraph 115-228(a)(i). Accordingly, the present entitlement to the \$100 would be sufficient, even if the payment of this cash was not directly traced to the cash received from the sale of the CGT asset.
17. As outlined earlier, this proposal would also require an amendment to paragraph 152-228(1)(b) – i.e. so that the reference to “vested and indefeasible interest” would be changed to “the specific entitlement”

Straddle contracts

18. Many trust deeds do not use a “tax equalisation clause”. That is, many trust deeds do not define income of the trust to equate to section 95 income. In such cases, the amount and timing of the capital gain would generally be determined using ordinary principles, taking into account the trust deed.

19. We highlight that the capital gains tax provisions create artificial taxing points in respect of the derivation of capital gains. For example, CGT event A1 deems a capital gains event to occur at the time the taxpayer enters into the contract. Due to these artificial timing provisions, a capital gain may (in many cases) represent a notional gain to the trust at the time of the CGT event.
20. For example, if a trustee enters into a contract to sell an asset in late June that settles after year end (i.e. is a straddle contract), the capital gain may only constitute a notional tax amount. At the time of the CGT event (and thus at year end), the trustee will still legally own the property that has given rise to the capital gain - being the underlying asset. We believe that this may result in issues when trying to create a vested and indefeasible interest in the trust property representing the capital gain by year end to satisfy the requirements of the proposed section 115-228.
21. In this regard, we note that in (the now withdrawn) PSLA 2005/1 (GA) the ATO was prepared to administer the streaming of notional capital gains in the following manner:
- 8. The Commissioner will accept assessing a capital gain to a trustee on behalf of a beneficiary or treating a beneficiary as having a capital gain or gains for the purposes of subsection 115-215(3) of the ITAA 1997 to the extent that the beneficiary either has:*
- by the end of the income year, a vested and indefeasible interest in the trust capital representing the trust's capital gain (including if the trust's capital gain is less than the accounting gain) or, if the trust's capital gain is a 'deemed' amount for tax purposes, they would have had such an interest if the gain were represented by actual trust capital; or*
 - been allocated the trust's capital gain no later than two months after the end of the income year. In determining whether the trust capital gain has been allocated, the Commissioner will rely on the way the trustee characterises it.*
- 9. In this practice statement 'the allocation of a capital gain' includes its crediting or distribution to a beneficiary, its payment or application on behalf of, or for the benefit of, a beneficiary or, in the case of a deemed capital gain, its allocation notionally by the trustee. An example of a deemed capital gain is one to the extent the market value substitution rule in section 116-30 of the ITAA 1997 applied to determine the capital proceeds.*
22. While we understand that the Treasury has indicated that they will not accept a “notional” allocation (i.e. at paragraph 1.53 of the Explanatory Memorandum), we believe that it will be critical for Treasury to provide a mechanism in the legislation that will allow for a specific entitlement to be created to a “straddle” capital gain. We believe that the provisions will fall short of their stated objective if this issue is not addressed.

23. Accordingly, we believe that (at a minimum) the second subparagraph of paragraph 8 of PSLA 2005/1 (GA) should be included within section 115-228 - in particular, the ability to “allocate” the capital gains to the beneficiary. We believe that the allocation method would be consistent with the wording used in section 207-58.
24. Furthermore, we believe that the Treasury needs to place an example in the Explanatory Memorandum that deals with a straddle contract, outlining that it is possible to stream a capital gain even where the capital gain straddles an income year.

Pay or apply

25. The Explanatory Memorandum, at paragraph 1.54 makes the following comment in relation to the creation of a vested and indefeasible interest:

1.54 It is sufficient for a beneficiary to have a vested and indefeasible interest in the amount, or for the amount to have been paid or applied for the benefit of the beneficiary.

26. In particular, the Explanatory Memorandum only refers to an ability to pay or apply the relevant amount. We highlight that this statement is too restrictive and we request Treasury to consider redrafting this explanation.
27. In addition to replacing the words “vested and indefeasible” with “allocated” in section 115-228 (as outlined earlier), we also make reference to paragraph 9 of Practice Statement PSLA 2005/1 (GA).

9. In this practice statement 'the allocation of a capital gain' includes its crediting or distribution to a beneficiary, its payment or application on behalf of, or for the benefit of, a beneficiary or, in the case of a deemed capital gain, its allocation notionally by the trustee. An example of a deemed capital gain is one to the extent the market value substitution rule in section 116-30 of the ITAA 1997 applied to determine the capital proceeds.

28. As a trustee may be able to allocate a capital gain to a beneficiary in ways other than by a payment or application, we believe that paragraph 1.54 of the Explanatory Memorandum should not be so confined and should be amended respectively.

Other notional capital gains

29. There is some uncertainty as to whether a deemed capital gain from the application of a market value substitution amount can be streamed.
30. For example, a trust may sell property to a non-arm's length party for \$100, whereby section 116-30 may apply to treat the capital gain as being \$1000. The whole of the “ordinary capital gain” of \$100 may have been distributed to Beneficiary A. Under PSLA 2005/1 (GA), it was clear that 100% of the notional capital gain of \$1000 would be allocated to Beneficiary A.

31. However, section 115-228 as currently drafted requires the capital gain that is represented by the trust property (\$100) to be the subject of a specific entitlement. It therefore creates some uncertainty as to whether the whole of the notional capital gain can be streamed in this case.
32. It is submitted that, in line with PSLA 2005/1, the whole of the notional amount should be allocated to the capital beneficiary in this example. We believe that this issue should be clarified by way of an example in the Explanatory Material. We understand that a different view may occur if there is no “ordinary capital gain”. However, at a minimum, we believe that it is appropriate to clarify this issue where there is an amount of an ordinary capital gain that is streamed to a beneficiary.

Summary of submission points

33. To summarise our submission points raised above, we request that section 115-228 be amended for the following items:
- a. To change the reference to “vested and indefeasible” to “specifically allocated”, in line with the wording used in section 207-58
 - b. To introduce a new test that clarifies that a present entitlement to an amount of trust property representing the amount of the capital gain should also satisfy paragraph 115-228(1)(a)
 - c. To ensure that the test of “specific entitlement” is not limited to the payment or application of an amount and is more in line with PSLA 2005/1 (GA) paragraphs 8 and 9

Ordering provision

34. We believe that it is important that Treasury ensures that the provisions are clear in respect of their ordering. In our view, it is not clear that Division 5B operates subsequent to the operation of Division 6 – that is, it appears to operate concurrently.
35. We believe that this will give rise to issues associated with the provisions, for example, determining a Division 6 percentage (which we believe will be influenced by the Division 5B adjustments).
36. We believe that it is preferable for an ordering provision to exist in the legislation. The ordering provision should indicate how the provisions are applied and in which order. That is, Division 6 should be applied first, following by Division 115-C and 207-B, with Division 5B applying to adjust the income included in the assessable income of the beneficiary or trustee.

Rateable allocation of expenses

Allocation where there are only capital gains and franking credits

37. We are not sure that section 115-225(3) achieves the right outcome where the trust only has a capital gain and franking credits remaining (i.e. where direct expenses are greater than franked distributions).
38. For example, assume the trust derives a non-discount capital gain of \$100, a dividend of \$70, incurs direct dividend expenses of \$70, and has a franking credit of \$30 attached to the dividend. Assume there are other rateable expenses of \$10. Assume the trustee resolves to distribute 100% of the net income to Beneficiary A and that income is defined to include capital gains.
39. In this example, there is no specific entitlement to either the capital gain or the franked distribution. The Division 6 percentage will be taken to be 100% for Beneficiary A. However, paragraph 115-225(3)(c) will require a portion of the \$10 rateable expense to be allocated to the franking credit (and not the franked distribution). We are unsure why this should be the case. The operation of this provision (in this example) would mean that the amount of the franking credit that flows through the trust will be rateably reduced, which would indicate a change in policy in respect of the flow through of franking credits.
40. In our view, the rateable allocation of \$10 should only be applied to net capital gains and frankable distributions – i.e. to actual amounts. It should only be by default that any amount not allocated under this rule would be allocated to the franking credits. This would happen by way of course, as there would be no income of the trust remaining to make a beneficiary presently entitled to the income of the trust.

Allocation to franked distributions

41. We request that Treasury outlines more clearly how expenses are rateably allocated to dividends where paragraph 115-225(2)(b) applies. The outcome is shown in Example 1.9 however, there appears to be no basis for this allocation in the legislation.
42. That is, after applying the rateable allocation in subsection 115-225(2), there are \$50 of other expenses that need to be rateably allocated to the dividends. The example allocates the whole of this amount to the franked distribution and no amount to the franking credit. We agree with this approach and believe that this is consistent with correct policy. However, we are not sure how this approach is substantiated by the legislation.
43. It would be our preference for Example in 1.9 of the Explanatory Memorandum to clearly state how the expenses are to be allocated, where there is a franked distribution and franking credits.

Trust to trust distributions and streaming

44. The legislation and Explanatory Memorandum have been drafted such that capital gains and dividends retain their character as they are streamed through a trust. While the Explanatory Memorandum is silent in respect of the ability to stream capital gains and dividends through multiple trusts, we believe that there is a clear inference that this is consistent with the policy of the provisions and that the provisions will operate to allow such streaming.
45. Should this not be the case, or should Treasury believe that there are technical problems with achieving this outcome, we believe it will be absolutely critical for Treasury to ensure that amendments are made to the Exposure Draft to ensure that such technical issues are addressed in the final legislation. Furthermore, to avoid any doubt, the Explanatory Memorandum should clearly state that it is possible to stream capital gains that have been received by a trust from another trust.

Commissioner's discretion

46. We would encourage Treasury to consider the introduction of a Commissioner's discretion to accompany the operation of the streaming provisions. That is, we believe it is important for there to be an ability to divert from a stringent application of the "allocation" rules where the trustee can demonstrate that there was a clear intention to stream certain gains.
47. We believe that this is critical, especially in the first year of operation, as trustees will not have time to understand the exact requirements of the legislation in time for preparing 30 June 2011 resolutions and distributions. Furthermore, trustees may have already dealt with the trust property (e.g. by way of reinvestment), which may make it difficult to satisfy the stringent requirements of section 115-228 (e.g. if there are no changes to that provision).

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Should you have any queries in relation to this submission, please call me at any time on 03 8610 5170, or Chris Birchall on 03 8610 5586.

Yours sincerely



A M KOKKINOS
Executive Director