

TAX BULLETIN

An update publication for our clients

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Reform of the Taxation of Trusts

Introduction

On 21 November 2011 the Government released a consultation paper (“the Paper”) as the next stage in its plans to rewrite the taxation of trust provisions. The closing date for submissions on the Paper is 10 February 2012.

Whilst the Government has specifically ruled out taxing trusts as companies in the Paper, all other trust related issues are on the table for discussion. However, the Government has also stated that the more issues that are raised for consideration (or are required to be addressed) the longer will be the likely legislative timeline.

The main objective of the review is to rewrite the trust income tax provisions in Division 6 of the 1936 Tax Act into the 1997 Tax Act. In doing so, the Government has outlined a number of issues that may need to be addressed in the rewrite of Division 6. Issues that are covered in the Paper include:

- determining the scope of a trust (for example, should bare trusts should be covered by the rewritten rules and do trusts created from assignments need to be recognised for taxation purposes?);
- technical issues associated with the operation of the trust provisions (such as the difficulties in creating present entitlements to income by 30 June; the rate of taxation paid by trustees; whether streaming and character flow-through is possible under the current rules; and the allocation of trust expenses amongst the classes of income derived by a trust); and
- the interactions of the trust rules with other parts of the taxation law (such as the integrity measures in Division 7A of the 1936 Tax Act - which are designed to ensure that the profits of companies are not paid, lent or forgiven by a private company to a shareholder or the shareholder’s associate in a non-taxable form).

The Paper puts forward three possible models for taxing trust beneficiaries that could be adopted in the rewrite - namely:

1. a ‘patch’ model - which would involve retaining the existing structure of Division 6 but defining the phrase ‘income of the trust estate’ for tax purposes;
2. a proportionate within a class model - which would seek to codify the ATO’s administrative practice under Taxation Ruling TR 92/13 (which applied up until 30 June 2010) and allow a trust to separate its income into different classes. The taxable amount of each class of income would then be allocated to a beneficiary based on their “proportionate” share of each of the classes of income; and
3. a trustee assessment and deduction (“TAD”) model - which would make the trustee of a trust assessable on the income they derive but allow a deduction to the trustee for distributions it makes to the beneficiaries of the trust (who would then be assessed on the distributions they receive and with the character of the income distributed to them retained).

We anticipate that the Government will aim to make a decision on the approach to the rewrite by May 2012 - i.e. as part of the 2012/13 Budget.

Preliminary comments

According to the most recent ATO taxation statistics there were 663,392 trusts that lodged tax returns in Australia in the 2009 income year - the vast majority of which are used by small to medium size ("SME") businesses.

While many would agree that there are problems with the current trust taxation provisions, the Government needs to be very careful in proposing wholesale reform of the trust taxation provisions.

All stakeholders (including the Government) would need to closely consider the implementation and compliance issues associated with moving to any new model for the taxation of trusts. For example, will current trust deeds allow trustees to apply the new provisions? What will be the changes to the preparation of tax returns and accounts? How will SME businesses fund 'cash' distributions if they are required under a new model? Will there be changes to the way in which financial accounts will need to be prepared? What will be the consequences if there is an amended assessment (will the trustee pay tax)? Is it appropriate to have a 46.5% trustee tax rate under any new model?

SME business taxpayers are already facing high (and often unnecessary) compliance costs. Significant changes to the trust taxation provisions would add even greater compliance burdens in the short term.

On that point, it is positive to note that the Government is not rushing the consultation review process - with submissions due on 10 February 2012. Given that it took almost six months to rewrite the specific trust streaming provisions, we expect that the new (general) provisions would not realistically commence before 1 July 2014. An earlier date would be ambitious and could be fraught with danger.

As the proposed reforms to the taxation of trusts will affect the vast majority of the more than 660,000 trusts that lodge tax returns each year (i.e. apart from the relatively small number of trusts that may be able to take advantage of the proposed investment manager and managed investment trust regimes), we would encourage you to consider the consequences of the various reforms proposed and to contact us if you have any concerns with what the Government has announced.

Detailed comments on the Paper

1. Trusts will not be taxed as companies

Whilst the Government had previously announced that trusts would not be taxed as companies (in Press Release 16 of 2010 setting out its response to the High Court's Bamford decision) and that trusts are "a legitimate feature of how Australians conduct their financial affairs" (to quote from the Assistant Treasurer's speech to the Taxation Institute's 26th National Convention in Brisbane on 4 March 2011), it was nonetheless good to see in the Paper a specific statement that:

The Government has ruled out taxing trusts as companies as it would be a major departure from the current policy framework.

2. Identified problems with the current taxation provisions

While the Paper does not cover all of the current problems with the taxation of trusts, it does outline a number of issues that could be addressed in the rewrite. These issues include the following.

Scope of the trust taxation provisions

Recently, the ATO has expressed a view that any trust relationship requires a trust to be identified for taxation purposes. For example, trusts created from assignments need to be recognised for taxation

purposes according to the ATO. The critical issue with this ATO view is that any losses generated will not flow through to the beneficiary due to the operation of the trust taxation provisions. Such an outcome is not appropriate where the beneficiary is at risk of making the loss.

The Paper indicates that the Government could consider clarifying the scope of the trust taxation provisions, to ensure that certain arrangements are not inappropriately included within the new provisions.

Rate of taxation paid by a trustee

Under the current law, undistributed amounts of trust income (usually deliberate accumulations and 'accidental' undistributed amounts) are assessed to the trustee - typically at the top marginal rate (plus Medicare Levy). Subsequent distributions of these amounts are generally not taxable.

The Government has specifically asked for comments "on whether there are alternative approaches to the current treatment of unallocated amounts that balance efficiency, equity, simplicity and integrity concerns."

We believe that: (i) the rationale for maintaining a trustee penalty tax rate of 46.5% is highly questionable in today's taxation climate and that the trustee rate of tax should be no more than the corporate tax rate (currently 30%); and (ii) reducing the trustee rate of tax to no more than 30% is also likely to resolve many of the Division 7A issues associated with trusts.

Determining present entitlement by 30 June

In order to avoid undistributed amounts of trust income being taxed in its hands, the trustee of a trust must resolve to make beneficiaries presently entitled to the trust's distributable income - typically by 30 June.

In light of the inflexibility of the legislative requirement that present entitlements must arise by the end of the relevant income year, as well as the administrative impracticality that this may present for trustees, the Paper requests stakeholders consider other alternatives.

For example, the Paper suggests that: (i) the 'specific entitlement' concept used for streaming capital gains and franked dividends (which requires that a beneficiary has received, or can reasonably be expected to receive, the net financial benefit referable to a capital gain or franked distribution) could be extended more broadly; or (ii) the concept of a 'distribution' of money (or property) that is actually paid to or applied on behalf of a beneficiary could be used.

Streaming and character flow-through

Character flow-through refers to the idea that the character of amounts in the hands of a trustee is retained when those amounts are distributed to the beneficiaries of a trust. However, under the current income tax law, the ATO has raised doubts as to whether character retention is effective unless there are specific provisions in the tax law that attribute specific tax characteristics to certain amounts.

The term 'streaming' refers to the ability of a trustee to direct different types of income to different beneficiaries of a trust. There remains confusion about whether 'streaming' of particular types of income, profits or gains (other than capital gains and franked dividends) to particular beneficiaries is effective for tax purposes.

The Paper puts forward two different approaches that could be adopted to provide clarity about when amounts received through a trust retain their character for tax purposes:

1. the tax law could include a generic rule providing for character retention for amounts received through a trust; or
2. the tax law could include specific rules to provide for character retention for specific types of income.

Allocation of expenses

The term 'income of the trust estate' is a net, rather than gross, concept - it refers to the gross income of a trust reduced by any allowable expenses. The way in which the trustee of a trust allocates expenses can be important as it can significantly alter the tax outcomes for individual beneficiaries or particular classes of beneficiaries in cases where the beneficiaries of the trust are entitled to different classes of income.

Under the existing law, the allocation of expenses has largely been determined in accordance with the general rule that expenses should be apportioned on a 'fair and reasonable assessment of the extent of the relation of the outlay to assessable income' - subject to the application of the relevant trust deed.

The Paper outlines three possible ways in which trust expenses could be treated:

1. specific legislative rules could be introduced that prescriptively govern the treatment of expenses - particularly where it is necessary to allocate them against different classes of income;
2. a general legislative rule could be introduced to largely codify the existing common law principle that expenses should be apportioned on a fair and reasonable basis (without any ability for trust deeds to override it); or
3. maintain the status quo. Broadly, this would result in expenses continuing to be attributed on a 'fair and reasonable assessment of the extent of the relation of the outlay to assessable income' - subject to the terms of the trust deed.

Application of section 99B of the 1936 Tax Act

Broadly, section 99B applies to include certain trust distributions (i.e. income and/or capital amounts paid to or applied for their benefit during an income year) in the assessable income of a beneficiary who was a resident at any time during the year to the extent that the amount has not previously been subject to tax.

The explanatory memorandum that accompanied the introduction of section 99B highlights that the provision will normally only apply where accumulated foreign source income of a non-resident trust estate is distributed to a resident beneficiary. However, given the current expansive wording of section 99B some uncertainty exists about whether it may technically apply to distributions of tax preferred amounts - i.e. any income of the trust for trust law purposes that is not included in its assessable income.

The Paper therefore, proposes that section 99B could be clarified to ensure it better reflects its intended scope.

Interaction with Division 7A

Division 7A is an integrity measure designed to ensure that the profits of companies are not paid to shareholders without being subject to the appropriate amount of tax. It ensures that amounts paid, lent or forgiven by a private company to a shareholder (or a shareholder's associate) are treated as deemed dividends, unless they come within specified exclusions.

Interactions between Division 6 and Division 7A generally arise where a trustee makes a corporate beneficiary presently entitled to income of the trust but retains the amount for use in the trust (such as

reinvesting in a business) - creating an 'unpaid present entitlement'. Interactions can also arise where amounts are lent to a trust by a private company.

The Government has indicated that it will continue to monitor the application of Division 7A and, if appropriate, will review the operation of the Division through a separate process. We believe however, (as mentioned earlier) that the majority of the interaction issues with Division 7A can be dealt with by reducing the trustee tax rate to the corporate tax rate and that this is an area the Government should look at during this review.

Other issues

The Paper identifies some of the other significant issues with the taxation of trusts that could be addressed to provide greater certainty for taxpayers, namely: (i) the legislative definition of a 'fixed trust' - which will be examined through a separate process; (ii) the complexities, significant uncertainty and additional compliance costs for trustees that arise under the current trust loss rules; and (iii) the complex rules governing when a trust can make a family trust election ("FTE"), the entities that can form part of a family group (including companies, trusts and partnerships included through interposed entity elections) and whether a 'test individual' for a FTE can be varied.

We believe that the above are all important issues and that the Government should ensure that they are addressed as part of this review.

3. Alternatives to the proportionate approach for taxing trust beneficiaries

In addition to addressing the issues outlined above, the Paper also considers whether we should change the way in which tax liabilities are attributed to beneficiaries.

Under the current trust provisions, a proportionate approach is used for taxing trust beneficiaries. For example, if two beneficiaries share in all of the income of a trust on a 50/50 basis they also share in the taxable income of the trust on the same basis.

From a practical perspective, adopting the proportionate approach as the basis for the rewrite of the provisions would provide continuity as to how the trust provisions have been applied. Most taxpayers and practitioners are familiar with this method and thus, using this method should not involve any significant new compliance costs.

However, the Paper outlines some problems under the current model. For example, the treatment of amended assessments under a proportionate approach can sometimes create an unfair tax impost on the beneficiaries who share in the amendment proportionately. Accordingly, the Paper outlines three possible alternatives to taxing trust beneficiaries - namely: a 'patch' model; a proportionate within a class model; and a TAD model.

A 'patch' model

The 'patch' model is arguably the least intrusive way to update the operation of Division 6. It involves retaining the existing structure of Division 6 but defining the phrase 'income of the trust estate' for tax purposes. The Paper canvasses three options for defining the phrase 'income of the trust estate' being: (i) use tax concepts; (ii) adopt accounting concepts; or (iii) retain the current approach.

The Paper states that based on submissions received on an earlier discussion paper ('Improving the taxation of trust income' - released on 4 March 2011), the preferred approach would be to use tax concepts. We note that if this approach is adopted it could prove problematic for trust deeds that have

been drafted without income definitions that seek to equate the 'income of the trust estate' with the trust's taxable income.

A proportionate within a class model

This model would seek to codify the ATO's administrative practice that was provided up until 30 June 2010. Under Taxation Ruling TR 92/13, the ATO allowed a proportionate approach to be applied within the various classes of income of a trust.

Essentially, the approach would require the trustee to split the income and net income of the trust estate into consistent classes of income - which can then be allocated to beneficiaries. For example, under this model it will be possible to distribute 100% of a particular class of income to one beneficiary - with the remaining beneficiaries then taking proportionate shares of the other classes of income derived by the trust.

Given that TR 92/13 allowed the existing trust taxation provisions to be administered in a practical manner (over the period from 1992 to 2010) and is well understood by the ATO and taxpayers/practitioners, a rewrite of the trust provisions under this approach could provide the greatest certainty to taxpayers going forward.

TAD model

A TAD model is one where the trustee of a trust is assessable on the income they derive but a deduction is provided to the trustee for distributions it makes to the beneficiaries of the trust (up to the amount of the assessable income of the trust). The distributions made by the trustee are then taxable in the hands of the beneficiaries who receive the distributions. Any undistributed amount would be taxed in the hands of the trustee.

The model is effectively a 'quantum approach' based on distributions of taxable income rather than a concept of 'entitlement' to income. As the distribution would be linked to the assessable income of the trust, the distribution would also be tagged with a tax character (i.e. to allow full character flow-through).

For example, if the trust derived \$100 of interest income a distribution of \$100 would be deductible to the trustee. The beneficiary would then be assessable on \$100 - which would be tagged as interest income.

Under a TAD model, if the trustee distributes all of its assessable income then no tax would be payable by the trustee. Broadly, this ensures that trustees are only assessed on taxable amounts that are retained in the trust. The definition of a distribution will therefore, be critical under this model. While the Paper outlines that 'cash' distributions are likely to be required, practically this would impose financing difficulties for SME businesses unless unpaid distributions are also allowed (i.e. as with companies and dividends).

4. Practical considerations in changing the trust taxation provisions

As noted above, there are a number of practical considerations that will need to be dealt with in any changes to the provisions covering the taxation of trusts. For example, will current trust deeds allow trusts to apply the new method or will they need to be amended? What changes to the preparation of tax returns and accounts will be needed? How will SME businesses fund any 'cash' distributions required under a new model? Will there be changes to the way in which financial accounts will need to be prepared - for example, for the purposes of compliance with external funding requirements? Who

will pay tax on any amended assessments? Is it appropriate to have a 46.5% tax rate under any new model?

In particular, any use of a TAD model may increase the scope for trustee assessments - both for intentional accumulations and unintentional unallocated amounts. For example, if there is an understatement of assessable income in a year due to an amended assessment the trustee would pay tax on any increase (as the amount would not have been distributed to beneficiaries) - which could, in turn, breach a banking covenant that there will be no trustee assessments.

Further, to the extent that the model chosen represents a significant departure from the current trust taxation provisions, there may be additional costs associated with the need to inform and educate trustees and beneficiaries about their new obligations.

It is therefore, important that the Government consults extensively on any proposed changes and that all amendments (i.e. even prima facie minor ones) are appropriately 'road tested' before being implemented into law.

Further Information

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