Some key objectives and implications

Underpinning the detail discussed below are a few objectives which the trust reform project is aimed at achieving. These objectives are not articulated in the Options Paper but the outcomes which the various models accomplish reveal some of the concerns of those behind the scenes:

- the allocation of the tax owed on taxable income will in future be made by reference to a criterion that is more comprehensive than just the ‘income of the trust estate’;
- that criterion will probably be designed in such a way that it cannot be affected by anything in the trust deed or the exercise of any power by the trustee;
- because the strictures of tax law will now be paramount, problems will arise where trust deeds, as currently drafted, cannot accommodate the way that tax law will operate;
- the rules for making the beneficiaries liable to the tax (instead of the trustee) will all but require that an amount of cash is distributed to the beneficiaries by the time they lodge their returns. The maxim that ‘the tax liability should follow the money’, apparently also implies that ‘the tax liability should not follow unless there is money’;
- in the case of capital gains, the amount of cash that will have to be distributed will likely be the gross amount of the gain ignoring any available discount (although reduced by capital losses); and
trustees will be liable to pay tax on a trust’s taxable income in more situations. For example, there is a discussion of a possible ‘trustee tax and beneficiary credit’ system akin to dividend imputation, and, in what appears to be a new policy, the trustee will always be liable to pay the tax (presumably, with no credit) on amounts of taxable income arising under ‘integrity rules’.

The third of these objectives, linking the tax consequences to cash distributions, will create significant problems:

- for property trusts with material capital gains that are not distributed to beneficiaries in a particular year;
- for all trusts where tax law creates significant non-cash inclusions in taxable income, such amounts arising under TOFA, shares of partnership income or amounts arising under the CFC rules;
- for all trusts where the tax law triggers taxable income in periods other than the one when income is earned for accounting purposes and available for distribution; and
- for all trusts where errors or minor variations are discovered after the income year has been closed.

The Options Paper makes no reference to the separate ‘attribution regime’ being developed for MITs. Instead, the Options Paper has been written with only the small business and household audiences in mind. But it is clear that these rules will be applied to all MITs which do not qualify for the proposed attribution regime, and to many of the trusts into which MITs invest. Hence the discussion below is directed to how the proposed models would operate when applied to MITs that will not qualify for the proposed MIT attribution regime and to the trusts in which MITs and non-MIT trusts invest. The Appendix to this Tax Brief compares the proposed models with the proposed attribution regime for MITs.

2 Background

The Assistant Treasurer announced in December 2010 that Division 6 would be re-written in light of issues that were said to arise from the High Court’s judgment in Bamford.

A discussion paper, Improving the Taxation of Trust Income, was released by Treasury in March 2011. It focussed principally on options for aligning the amount of tax law and trust law income and on streaming types of income between different classes of beneficiary (see our Tax Brief at http://www.gf.com.au/829_979.htm).
This was followed in November 2011 by a consultation paper, *Modernising the Taxation of Trust Income* ("Consultation Paper") which set out some models for taxing trust income (see our comments at [http://www.gf.com.au/1115_1149.htm](http://www.gf.com.au/1115_1149.htm)). Three models were offered, referred to as:

- the ‘patch’ model (aligning the ‘income of the trust estate’ closer to tax concepts and trying to ensure the ‘income of the trust estate’ is an amount available for distribution to the beneficiaries of the trust);
- the ‘proportionate within class’ model (beneficiary is separately assessed on a share of each class of the trust’s income); and
- the ‘trustee assessment and deduction’ model (beneficiaries are assessed on amounts they receive; amounts that are not distributed, including the fictions in ‘taxable income’ that can’t be distributed, are taxed in the hands of the trustee).

The Options Paper appears to abandon the first model and instead develops the remaining two, offering more detail on each.

### 3 The models

Much of the focus of the Options Paper is on elaborating the various models. This is hardly surprising given that the Consultation Paper devoted just 6 pages to this key issue.

#### 3.1 The proportionate assessment model (‘PAM’)

The ‘proportionate within class’ model is renamed the ‘proportionate assessment model’ but will work in essentially the same manner – that is, each beneficiary is assessed ‘on a proportionate share of the trust’s taxable income equal to their proportionate share of the ‘trust profit’ of the relevant class’.

At first glance the PAM could be thought of as capturing two variations to the current rules:

- the tax liability will now be based on how a beneficiary shares in the ‘trust profit’, including capital gains, rather than just the amount of ‘income’ of the trust; and
- the tax liability will be allocated by looking at a beneficiary’s share of each class or component of ‘trust profit’ individually.

Just how these variations will work is explained in some more detail in the Options Paper but some key issues are still unresolved.

Capital profits would be treated as forming part of ‘trust profit’ for this purpose. This means the tax liability would now track how beneficiaries share in trust income and capital profit, not just their share of trust income.
Secondly, ‘trust profit’ would likely be a defined term in the tax legislation. This would negate the effect, for tax purposes, of provisions in a trust deed which allowed a trustee to designate which amounts are ‘income of the trust’. The definition of ‘trust profit’ would be –

ordinary income for that year plus gross capital gains, net of expenses, losses or outgoings properly chargeable against such amounts at general law, and less any amounts that are subject to withholding tax.

It seems this definition is trying to express accounting-based notion, rather than something based on the concept of taxable income.

The notion of ‘classes’ of trust profit adds a degree of complexity that does not exist in current law. But just what is meant to happen is left vague; it is not clear from the Options Paper just where these classes will come from, and what the classes will be. The Options Paper is largely silent. It does not say, for example, whether these ‘classes’ only arise where the terms of the deed create classes or whether there will be a legislated set of classes for all trusts. Nor does it say whether classes will be mandatory. Apparently exempt and NANE income will always represent separate classes but the Options Paper also says, ‘the trustee can break the trust profit up into … classes’ which suggests that doing so will be optional.

The only thing that is clear from the Options Paper is that the creation of (or refusal to create) classes will not be effective to allow a trustee to recharacterise amounts in a way that doesn’t ‘correspond with the actual legal nature of the amounts’. This restriction might also prove critical when looking at powers to characterise and attribute expenses.

The Options Paper also offers no further guidance on one of the most difficult aspects of a class-based mechanism – what happens if there is an overall ‘trust profit’ but a loss arises in one of the classes?

3.2 The economic benefits model (‘EBM’)

The ‘trustee assessment and deduction’ model is renamed the ‘economic benefits model’. It seems to be Treasury’s preferred model. The model has been developed in the Options Paper but it is still, at heart, a deduction-based idea – the trustee is taxed on any amounts of taxable income which have not been appropriately ‘conferred upon’ [to use a neutral term] beneficiaries.

Unlike the PAM (which uses the decidedly non-tax law term, ‘trust profit’), the EBM works from the taxable income of the trust and reduces the trustee’s liability to pay tax on that amount by amounts of taxable income which are conferred upon the beneficiaries. This means that, as in the PAM, the tax liability of beneficiaries is affected by their entitlements to all assessable income, including capital gains, not just their share of trust income.
The key to the EBM is the rule which describes what must happen in order for the trustee not to be assessed on any of the taxable income. In the Consultation Paper, beneficiaries were to be assessed on amounts they receive, and amounts of taxable income not distributed in cash or property are taxed in the hands of the trustee. The clear emphasis was on cash flow – an ‘actual payment of cash or property to a beneficiary … and an application of cash or property for [their] benefit …’

At first glance, this emphasis on cash flow is slightly relaxed in the Options Paper: ‘beneficiaries [are taxed] on taxable amounts distributed or allocated to them …’ An amount will be treated as being ‘distributed’ if it is ‘credited to’ or ‘unconditionally set aside for’ the beneficiary. While ‘allocation’ is a word with much broader connotations, in the Options Paper the notion of ‘allocation’ is used principally for ‘amounts that cannot be distributed because they have not yet been received’. The Options Paper gives the example of ‘allocating’ the capital gain arising when a contract is signed but not completed by the end of a year.

The Options Paper goes a little way to addressing one of the main concerns with the version in the Consultation Paper – that the requirement for a cash flow seriously interferes with the distribution policies of trusts. The Options Paper explains that a distribution could arise where there is no cash flow: for example, from a trustee resolution to distribute and a corresponding agreement to loan back the funds, or from setting aside an amount to be held on a separate trust. But in all the examples in the Options Paper, cash has either been paid to beneficiaries or applied for their benefit, or if not, they could demand it immediately.

The impression that cash will have to be paid is reinforced by the discussion about ‘allocations’ that are made but not followed by a cash-flow. The Options Paper proposes two treatments. If the amount is allocated to a beneficiary but cash has not been distributed to them by the time the beneficiary lodges its return:

… the trustee would be assessed on behalf of the beneficiary in accordance with the Income Tax Rate Act 1986, similar to the current mechanism for taxing those beneficiaries under a legal disability… When the beneficiary subsequently receives the amount, it would be included in their assessable income and they would obtain an offset equal to the amount of tax paid by the trustee.

(How the trustee is able to determine whether or not beneficiaries have lodged their returns is not explained.)

However, at some point, the system changes, because in some cases:

… where a beneficiary has an amount allocated to them [but] not distributed to the beneficiary by the relevant time …, the amount would instead be assessed to the trustee at the trustee tax rate (with a credit for tax paid).
In both cases, it appears that allocation without a subsequent cash flow is insufficient to shift the tax liability to the beneficiary.

The model has several other problems. One is how to ‘distribute’ [or even ‘allocate’] the taxable income generated by a tax fiction. The Consultation Paper acknowledged that in such cases no cash flow could occur and so it proposed that the trustee would be taxed on ‘taxable income with no underlying economic benefits capable of distribution’ – which is Treasury’s way of describing these fictions. But the Options Paper is more ambiguous. One part of the Options Paper suggests that the tax liability on two tax fictions – franking credits and foreign tax offsets – will always follow the tax on the underlying dividend or foreign income; another part suggests that trustees will always be liable to pay the tax on a trust’s taxable income that arises under ‘integrity rules’; but how the trustee is to ‘distribute’ other elements of taxable income which might not involve any cash receipt – amounts arising under TOFA, shares of partnership income or amounts arising under the CFC rules – is not explained.

A similar problem finding the cash for a distribution will arise from timing differences between tax and trust law requirements. In addition, it is hard to see how a trustee is able to ‘distribute’ funds to extinguish a tax liability when the available cash has been disbursed on a non-deductible outlay.

A further problem is identification and ordering. A trustee might hold funds which represent amounts that are assessable income, exempt income and trust capital. The Options Paper assumes that the character of these amounts is evident by examining the amounts in the trustee’s hands, but the Options Paper does not explain how to decide which amounts are being distributed. The Options Paper says that ‘if the amount [distributed or allocated] does not represent part of the trust’s taxable income during the income year, then the trust’s taxable income will not be reduced’ but this simply begs the question.

Under this model there is also an important question about the continued ability of trusts to distribute tax preferred amounts without triggering further tax at the investor level. The Options Paper says that beneficiaries will be assessable on amounts distributed to them ‘to the extent that the trustee has been able to reduce the trust’s remaining taxable income’. This suggests that the beneficiary’s taxable distributions will be capped at the amount of taxable income calculated at the trust level; in short, all tax-preferred amounts would survive in the hands of the beneficiary. But this may be reading too much meaning into this particular passage.

A related question is, what happens to the trust in such a case? For example what happens if the trustee makes a cash distribution of $120, when the taxable income of the trust is $100. In the examples to the Options Paper, the trust has no remaining taxable income for that year and the surplus distribution of $20 appears to have no effect on the trust’s position in the next year.
Finally, if errors or minor variations are discovered after the income year has been closed (which will probably be 31 August), the trustee may well have under-allocated or under-distributed. This model shifts the tax consequences of that problem to the trustee.

4 Issues of scope

The second issue which the Options Paper explores is scope – will the new rules be exhaustive and which trusts will be subject to them?

The Options Paper poses the possibility that the new rules might be an exclusive statement of the taxation of income passing through trusts, but Treasury is clearly sceptical; the Options Paper suggests that it would ‘be unfair for certain amounts to remain untaxed in the hands of beneficiaries if another part of the income tax law would otherwise bring them to tax’. Just how this fits with the earlier proposition that beneficiaries are assessable only ‘to the extent that the trustee has been able to reduce the trust’s remaining taxable income’ is not obvious.

With regard the range of trusts that will be subject to the new rules, the Options Paper appears prepared to implement industry practice that bare trusts are simply ignored, but wants to define exactly the kinds of trusts that would qualify as ‘bare trusts’. There is a suggestion that IDPS arrangements might be transparent, and dealt with outside the new trusts regime.

5 Other miscellaneous comments

While most of the Options Paper is focussed on these two issues – design options and issues of scope – there are other scraps of text spread throughout the Options Paper which offer some interesting insights into Treasury’s current thinking:

- any new model will provide that ‘all amounts that flow through a trust would retain the character that they had in the hands of the trustee when assessed to the beneficiaries’ unless there is a specific provision to the contrary;

- any new model will allow amounts to be streamed ‘in a tax effective way to particular beneficiaries’. Interestingly, the Options Paper suggests that the legal foundations for this to occur are modest: apparently it will not be necessary ‘that there [is] a separate and explicit streaming power in the trust deed; just that the trustee must comply with the trust deed and trust law more generally’;

- the Options Paper contemplates the possibility of adding a rule which directs that expenses are to be allocated against amounts of income ‘on a fair and reasonable basis’;
Some Progress on Trust Tax Reform

- there is a clear indication that trustees will be formally provided with a two month window in which to do the trust housekeeping – that is, decisions about entitlements and documenting trustee resolutions will only need to occur by 31 August in each year;

- the law will be amended to provide a clear statement that the ATO cannot assess a trustee more than 4 years after a trust return is lodged;

- it seems very likely that the penalty rate applicable where the trustee is assessed because no beneficiary is presently entitled will be retained at the current level; and

- it seems very likely that trustees will have to notify beneficiaries of their entitlements and liabilities along the lines of the recently introduced reporting requirements. This will be an issue mainly in the SME sector.

6 Next steps

This is an important project, with significant impacts for the managed funds industry and the property sector. The Assistant Treasurer’s Press Release of 30 July 2012 announced that the new rules will start on 1 July 2014, so the measures being canvassed will be subject to more consultation and revision before being finalised.

The closing date for submissions on the Options Paper is 5 December 2012. Greenwoods & Freehills is able to assist clients who wish to make a submission.
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These notes are in summary form designed to alert clients to tax developments of general interest. They are not comprehensive, they are not offered as advice and should not be used to formulate business or other fiscal decisions.

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### Issue Proposed Division 6 position Proposed rule for MITs applying the ‘attribution regime’

<table>
<thead>
<tr>
<th>Issue</th>
<th>Economic Benefits Model – beneficiaries are assessed on the amount of taxable income distributed or allocated to them</th>
<th>The actual basis for attributing the taxable income of a trust under the MIT regime has yet to be agreed although the guiding principle has always involved the trustee making a determination on a fair and reasonable basis consistent with entitlements under the trust deed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basis of assessment</td>
<td>Proportional Assessment Model – beneficiaries are assessed on the share of ‘trust profit’ of each class to which they are presently entitled</td>
<td>In both models, the trustee is taxed on the balance</td>
</tr>
<tr>
<td>Distribution requirement</td>
<td>In both models, the rules have the effect of requiring the trustee to distribute cash or property to or for the benefit of beneficiaries</td>
<td>No requirement to make any distribution in cash in order to sheet the taxable income home to beneficiaries on a proportionate basis</td>
</tr>
<tr>
<td>Character retention</td>
<td>Yes, unless varied by other parts of the tax law</td>
<td>No special rules have yet been proposed but the same approach will probably apply to MITs</td>
</tr>
<tr>
<td>Franking credits</td>
<td>Automatically attach to a trust distribution or allocation which includes a franked distribution received by the trustee</td>
<td>No special rules have yet been proposed but the same approach will probably apply to MITs</td>
</tr>
<tr>
<td>Issue</td>
<td>Proposed Division 6 position</td>
<td>Proposed rule for MITs applying the ‘attribution regime’</td>
</tr>
<tr>
<td>------------------------------------------</td>
<td>---------------------------------------------------------------------------------------------</td>
<td>--------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Foreign tax credits</td>
<td>Automatically attach to a trust distribution or allocation which includes foreign source income received by the trustee</td>
<td>No special rules have yet been proposed but the same approach will probably apply to MITs</td>
</tr>
<tr>
<td>Streaming</td>
<td>All amounts can be streamed. Apparently will not be necessary for trust deeds to allow streaming</td>
<td>May be difficult to qualify for MIT attribution regime if trust deed allows streaming (as entry to MIT attribution regime only accessible to trusts with clearly defined and identical rights)</td>
</tr>
<tr>
<td>Time for determining entitlements</td>
<td>31 August</td>
<td>90 days after the end of the income year</td>
</tr>
<tr>
<td>Trustee tax rate</td>
<td>Amounts taxed to the trustee suffer the top personal marginal rate (plus Medicare levy)</td>
<td>No special rules have yet been proposed but the same approach will probably apply to MITs</td>
</tr>
<tr>
<td>Issue</td>
<td>Proposed Division 6 position</td>
<td>Proposed rule for MITs applying the ‘attribution regime’</td>
</tr>
<tr>
<td>-------------------------------------------</td>
<td>----------------------------------------------------------------------------------------------</td>
<td>----------------------------------------------------------</td>
</tr>
<tr>
<td>Allocation of expenses</td>
<td>To be made on a ‘fair and reasonable’ basis</td>
<td>No special rules have yet been proposed but the same approach will probably apply to MITs</td>
</tr>
<tr>
<td>Tax-preferred income</td>
<td>Appears to remain non-taxable, unless dealt with by another part of the tax law</td>
<td>Same rules should apply to MITs, with the addition of CGT event E4 adjustments to beneficiaries’ cost base, both up and down</td>
</tr>
<tr>
<td>Amendment period for trusts</td>
<td>Deemed nil assessments of trustee and restriction on powers to amend</td>
<td>No special rules have yet been proposed but the same approach will probably apply to MITs</td>
</tr>
<tr>
<td>Deemed income under integrity rules</td>
<td>Taxed to the trustee at the top personal marginal rate (plus Medicare levy)</td>
<td>No special rules have yet been proposed but the same approach may be applied to MITs</td>
</tr>
<tr>
<td>Adjustments and errors (ie, unders and overs)</td>
<td>Taxed to the trustee at the top personal marginal rate (plus Medicare levy)</td>
<td>Special regime for ‘unders and overs’ within the monetary thresholds. ‘Unders and overs’ are to be taxable to the trustee.</td>
</tr>
</tbody>
</table>