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PRIVATE AND CONFIDENTIAL

Dear Sir/Madam

SUBMISSION - TAXING TRUST INCOME - OPTIONS FOR REFORM

Grant Thornton Australia Limited (Grant Thornton Australia) appreciates the opportunity to provide comments to Treasury on the Consultation Paper "Taxing trust income – options for reform" dated 24 October 2012.

Grant Thornton's response reflects our position as leading advisers to family groups and privately held companies and businesses as well as to smaller firms assisting that sector.

This submission contains our view on the preferred method for the taxation of trusts together with responses to the specific questions posed in the Consultation Paper.

Grant Thornton's view on the preferred trust taxation model

We support the policy principles listed in the Policy options paper in requiring that the model chosen provides certainty and minimises compliance costs and complexity while minimising anomalous results and manipulation of tax liabilities. This should promote the effective use of trusts, especially to provide stakeholders with the flexibility to plan their affairs in a manner that facilitates the building of wealth for the good of those stakeholders and the economy as a whole.

Economics Benefits Model ("EBM")

We believe the EBM approach is the more favourable model proposed by Treasury due to the simplicity of its operation and application. The model assesses beneficiaries on taxable amounts distributed to or allocated to them with the remainder of income being taxed in the hands of the trustee. With proper safeguards and a realistic trust tax rate, EBM provides the best reform opportunity to achieve the stated policy principles. It would also reduce the current distortive impact of trust taxation rules on trustee decision making.

Well implemented, EBM also has the potential to remove the current complexity arising from trust law concepts dictating the tax outcomes. Most family groups and their accountants are not equity lawyers; while trust law concepts remain linked to allocating the tax burden on trust income, complexity and compliance costs will continue to be high.

However our major concern with this model is the proposed 46.5% trustee tax rate for income retained in the Trust. This model requires determining actual (or deemed) distribution and allocation amounts by 31 August, which is not achievable in the broader community, especially for private groups needing the assistance of already busy accountants and tax agents. This would lead to considerable uncertainty and potential for error due to the harsh application of the 46.5% tax rate if trustees made errors, e.g. in their haste to meet this deadline. It can also operate harshly where taxable income exceeds available profits. The 46.5% tax rate is unfair and unrealistic in such a system and contradicts the policy principles. The EBM model is almost unworkable if trusts had a 46.5% tax rate.

Therefore if the Government insists on retention of the 46.5% trustee tax rate, we would not recommend the EBM approach. Rather, we would recommend the proportionate assessment model.

Proportionate Assessment Model ("PAM")

The PAM approach would be our favoured model if the trustee tax rate remained at 46.5%. PAM would operate in a similar fashion to the current trust taxation rules and its general application should be relatively familiar to the majority of trust users.

This familiarity would assist with transition to the new system.

However, current complexity is unlikely to be reduced: trust law principles would continue to dictate the tax outcome rather than the movement of funds and current workarounds to prevent the 46.5% trustee tax rate would still continue with the adoption of the PAM approach.

The Trust Tax Rate should be reduced to a realistic level

This consultation reveals an apparent undue fixation with preserving the tax rate of 46.5% for funds retained in Trusts. It is unrealistic to expect achievement of the desired policy principles while taxpayers operate under the spectre of a harsh penalty for "getting it wrong". This can only create unwarranted distortions where the "tax tail wags the dog", including needing to embrace structures and approaches that increase compliance costs and complexity.

Safeguards must be in place to prevent individuals sheltering their income from being taxed at their appropriate marginal tax rate. However, it is another thing completely for the system's primary safeguard to essentially operate as a sledgehammer for the mildest of breaches. If meaningful reform is to occur, the Government should examine the current policy framework in light of accepted practice: where trustees take extended timeframes to distribute their profits to individuals where they can distribute to associated private companies, but in the meantime are governed by Division 7A principles.

Rather than having the system effectively promote such cost and complexity, e.g. maintaining corporate beneficiaries, having trusts taxed at a more realistic rate on retained taxable income, say 30%, will better achieve the policy principles, especially by eliminating the distortive behaviour currently required to prevent an adverse tax rate applying.

Sensible safeguards can ensure achievement of policy principles: only taxing the trust where it truly continues to enjoy the economic benefit of any trust income and adopting something akin to Division 7A principles as a backstop. To align with current practice, a forced distribution after a period of say 7 to 10 years could be considered but this may create its own distortions.

Bare Trusts

A carve out should apply for bare trusts in the proposed trust taxation regime to avoid unnecessary complexity and compliance costs and the needless trapping of losses inside what are essentially nominee structures that are funded by those bearing the commercial risk.

Currently, such entities are not treated as trusts under an administrative arrangement applied by the Commissioner. Some examples are:

- parties to a commercial joint venture will often form a special purpose company to be the "public face" of the venture but all transactions are agreed to be those of the venturing parties. Arguably a trust technically exists in such cases, which are usually treated instead as a tax law partnership and taxed as a flow through

- instalment warrant trusts established by superannuation funds are trusts that currently are not required to lodge a separate tax return. Aside from extra needless compliance costs, if a Division 6 trust was regarded as existing in such circumstances, such trusts would need to account for costs attributed to assets held, meaning a potential for trapped tax losses if a period of low income arises

Carve outs or different rules could also be considered for certain types of trusts, including deceased estates and disability trusts where the imposition of a final tax calculated in accordance with individual tax rates appear to be more appropriate.

We would welcome the opportunity for further consultation on any aspect of this submission and the overall reform process.

If you have any queries, please contact me on 07 3222 0202.

Yours faithfully
GRANT THORNTON AUSTRALIA LIMITED

PM Banister

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Responses to Questions

Question 1 – Would introducing a 'fair and reasonable basis' principle into the legislation provide additional certainty for trustees and beneficiaries? What rules would be required to implement this principle?

The use of a fair and reasonable principle is not necessary. The Trustees should be able to allocate or not allocate expenditures as the Trustee sees fit. The Tax Acts do not require allocation of deductions between classes of income, merely that they be deductible. It should be the option of the Trustee to organise the Trust's taxable income in such a way to minimise the tax outcomes to the Trust or its beneficiaries whilst adhering to the Tax Law.

The examples on page 11 (Tessa's Trust) apportions deductions such that the Gross Capital gain is used and net dividends are used. The interest is incurred in deriving assessable income and the Trustee should be able to apportion as the Trustee thinks fit or as the Trust Deed directs.

No greater obligation should be required of the Trustee in discharging their obligations as Trustee.

Example 13 (on page 25 of the October 2012 Option Paper) provides an example of extending the obligation of the Trustee. It implies that the Trustee seek to apportion the accounting fee on a fair and reasonable basis where:

- the expenditure is deductible
- the expenditure is approximately 1% of revenue

By imposing a fair and reasonable basis we impose a "judgment rule" that simply adds the cost of complying with and enforcing our Tax Laws.

Question 2 - Would it be appropriate to extend the time for determining entitlements beyond 31 August for certain classes of trusts, where it is reasonable to expect that beneficiaries have a lodgement date later than 31 October? What features should such trusts have? Should the trustee be required to obtain the agreement of all beneficiaries? If so, should this be done on and opt-in, or opt-out basis?

The timing of the determination of the Trustee's exercise of discretion, or performing the Trustee's obligations under the Trust deed should not be linked to a fixed date other than the due date for lodgment of the Trust's tax return.

The lodgment of the Trust's tax return, in itself, should provide the requisite allocation of income tax issues for the Trust concerned. Put simply which ever method is adopted the lodgment of the tax return should reflect the Trustee's obligation under the deed and under taxation law to lodge the return for that Trust.

If the Trustee is required to exercise a discretion to apply either income and/or capital to a beneficiary then the Trustee must do so by the due date for lodgment of the Trust's tax return (either under a Tax Agent's lodgments program or 31 October if the Trust is not covered by an Agent's program). In signing the return the Trustee is declaring the correct taxable income(including capital gains) for income tax purposes of the Trust. If Trust Taxation law requires a Trustee to perform some function, for example, allocation of income, compare tax distributions and economic benefits, or stream classes of income, then such functions must be performed by the due date for lodgment of the Trust Tax return.

If the Deed requires the Trustees to undertake this function earlier, this should be a matter between the Trustee and the Trust Fund. Applying a fixed time provides an unnecessary burden on the Trustee in trying to draft resolutions to effect tax consequences when actual numbers are not known or are merely estimates. Further such resolutions may be dependent on other Trustees exercising discretions that then impact on that outcome or may distort the tax consequences. Extending the time should have the positive outcomes of decreased amendments, decreased error rate and higher standard of Trustee's compliance with both their duties under the Deeds and under Taxation law.

Q.3
a) How could the integrity, regulatory and fiscal issues associated with a lower rate be addressed without increasing complexity?
b) Would a 'tax and credit system' (akin to franking credits) increase compliance costs and be too similar to taxing trusts like companies on accumulations?
c) What else could be done to reduce the practical impact of trustee assessments?

For the EBM to be workable, the trustee tax rate should be lowered. If it is not lowered, trustees will face an adverse tax rate in situations beyond their control where it is not possible to make an actual distribution within the available time limits.

EBM requires determining actual (or deemed) distribution and allocation amounts by 31 August, which is not achievable in the broader community, especially for private groups needing the assistance of already busy accountants and tax agents. This would lead to considerable uncertainty and potential for error due to the harsh application of the 46.5% tax rate if trustees made errors, e.g. in their haste to meet this deadline. It can also operate harshly where taxable income exceeds available profits. The 46.5% tax rate is unfair and unrealistic in such a system and contradicts the policy principles. The EBM model is almost unworkable if trusts had a 46.5% tax rate. If meaningful reform is to occur, the Government should be willing to move on this.

If a lower rate applied, say 30%, safeguards must be in place to prevent individuals sheltering their income from being taxed at their appropriate marginal tax rate. But current accepted practice should influence what safeguards apply, especially due to the large number of trusts that currently distribute their income to associated private companies. The latter strategy obtains both the benefit of being able to retain trust income for extended timeframes and to apply a 30% tax rate.

Sensible safeguards can ensure achievement of policy principles: only taxing the trust where it truly continues to enjoy the economic benefit of any trust income and adopting something akin to Division 7A principles as a backstop. To align with current practice, a forced distribution after a period of say 7 to 10 years could be considered but this may create its own distortions.

Using a corporate beneficiary to cap the rate of tax at 30% has historically been used by many family groups. Division 7A has acted as a back stop to ensure tax could not be capped at 30% whilst the use of the funds is enjoyed by the shareholders or their associates. In particular Sub-division EA of Division 7A already captures many actions of a trustee.

Reducing the tax rate of the trustee to 30% should also be approached in the same way. Introducing a similar system such as Division 7A for payments/loans/debt forgiveness to related entities should be considered. Applying the Division 7A integrity measure fully to trusts in family groups which already use the corporate beneficiary approach to managing their tax exposure should not introduce significant new complexity if introduced appropriately. Further the net tax revenue should not significantly impacted but may result in additional tax revenues due to the broader application of Division 7A type principles to the trust itself. A clear understanding of what, for trust purposes constitutes a payment or a loan will be required. Other issues such as developing a concept of what is the equivalent of a distributable surplus for a trust will also be required.

None of the proposed changes to the way trust are taxed should alter the decision regarding whether a trust or a company is an appropriate structure. The trust deed is still the governing document for the operation of the trust and will continue regardless of the changes that are made.

Introducing a Division 7A styled system would only be acceptable with a credit system being implemented.

A tax and credit system should be introduced with the EBM to ensure that to the extent a beneficiary ultimately receives a distribution of income on which the trustee has already been assessed, the effective tax rate paid on that income is the beneficiary's marginal tax rate. This could be achieved by adopting something akin to the franking system. Alternatively, a tax offset could be provided so that a credit is provided with the same effect (eg to precisely align with the current system, a 22.9% offset is the same as the 30% franking credit on grossed-up dividend income).

Introducing a legislative requirement for trustees to notify all beneficiaries of their respective entitlements should not be required. Currently beneficiaries already need to know this information in order to attend to their own tax obligations. Changing the way trusts are taxed should not materially change the timing and the method in which trustees disseminate this information to beneficiaries. Setting a discrete time period such as that which is currently required in respect of distributions to beneficiaries who are exempt entities would only increase compliance costs associated with meeting the deadline and increase the incidence of errors and later adjustments. Further it would put undue pressure on the accounting industry to have this information accurately prepared in time.

Q.4 – Should trustees be able to fund distributions from other sources if an amount representing taxable income has not been recognised in its accounts, or otherwise been received or come home to the trust (bearing in mind the trustee's ability to allocate amounts as described below)?

Yes.

In particular where timing across tax years means that the income may not have been included in the accounts in the same year as the year of income. The trustee should have a longer period of time to distribute these amounts as often the accounting and trust law issues will not be fully resolved until after the following year of income.

The test should not necessarily be a test of whether the amount has been included in the accounts in the year of income in which the amount will be taxable. But rather that **as soon as practicable** after the amount is received it is included in the trust's income for that year. For example, consider CGT Event A1 where contract and settlement may straddle two or more tax years.

Further consideration needs to be given to amounts that can be deducted over time. Several provisions of the tax law require a deduction to be spread over several tax years, notwithstanding that the initial cash outlay occurs up front. Examples of this include the borrowing cost provisions, section 40-880 capital expenditure and the prepayment rules. As the trustee has the outlay in the first year, sufficient funds will not be available for distribution to beneficiaries in that year to fully eliminate any trustee tax liability. These differences are of a timing nature only, therefore anomalous outcomes may result.

Q.5 - The intention of the definition of trust profit used for the PAM is to capture all accretions to the trust estate excluding contributions of capital. Does the definition of 'trust profit' achieve that? If not, how can it be improved?

Introduction

As outlined in the Introduction, [1] the model for taxing trust income should be consistent with the policy principles outlined in the 2011 paper [2] – and in particular '*the provisions governing the taxation of trust income should provide certainty* ***and minimise compliance costs and complexity***' [emphasis added].

[1] Page 7, Taxing trust income – options for reform ("the Policy Options Paper")
[2] Modernising the taxation of trust income – options for reform ("the 2011 paper")

With this in mind we are of the view that the proposed definition of trust profit used for the Proportionate Assessment Model ("PAM") will not achieve this particular principle for three reasons:

1. the proposed definition is inconsistent with and not an appropriate interpretation of the High Court's judgment in *Commissioner of Taxation v Bamford* [2010] HCA 10;

2. taxpayers will incur increased compliance costs and added complexity as two further, and unnecessary, steps are required to determine and allocate trust profit; and

3. the assessment process will perpetuate something akin to the proportionate versus quantum debate that plagued section 97.

Inconsistent definition of trust profit

Regardless of any taxing provisions, trustees have a fiduciary responsibility and obligation to determine the income of the trust estate for trust law purposes in accordance with the trust deed. Trustees then consider which beneficiaries should be appointed with that income and having done so to make those appointed beneficiaries presently entitled to that income.

The PAM seeks to overturn many years of trust law and the fiduciary obligations imposed upon a trustee by the trust deed by seeking to narrow the meaning of 'income of the trust estate' by including a definition of 'trust profit' into the *Income Tax Assessment Act* ("ITAA").

This narrower definition seeks to encapsulate into the ITAA the Tax Office's views of 'income of the trust estate' outlined in TR 2012/D1. Submissions to the Tax Office on this draft ruling highlighted numerous concerns regarding the proposed view which should not be exacerbated in legislation.

In comparison to long-held views of trustees and their advisers the proposed definition of trust profit will cause considerable confusion.

Added costs and complexity

To then place the additional compliance costs and complexity, as alluded to earlier, into context – and as paraphrased from the PAM assessment process: [3]

	Current practice	**Proposed PAM**
1. The trustee determines trust law income in accordance with the provisions of the trust deed and appoints that income to beneficiaries	✓	✓
2. Trust profit (as defined by the ITAA) is calculated and is allocated to classes	✗	✓
3. Class allocated trust profit (to be defined in the ITAA) is shared amongst appointed beneficiaries	✗	✓

[3] Page 22, Taxing trust income – options for reform

	Current practice	Proposed PAM
4. Taxable income is calculated and is also allocated to classes	✓	✓
5. The taxable income is shared amongst appointed beneficiaries based on their proportionate share of class allocated trust profit (or under the current method – the trust law income)	✓	✓

The PAM is therefore introducing into the current system an additional two steps that will introduce complexity and uncertainty and add to the compliance costs of taxpayers. Depending on the outcome of the proportionate versus quantum debate that follows there is every possibility that these additional two steps will simply add to the compliance costs of trustees without changing the result.

For example, if a beneficiary is presently entitled to 100% of the 'income of the trust estate'. Assuming the proportionate methodology is adopted then that beneficiary will be presently entitled to 100% of 'trust profit' as well as the trust's 'taxable income'. Regardless of how the trustee determines the 'income of the trust estate' the inclusion of the additional two steps into the PAM assessment process will not alter the result.

Perpetuating the proportionate versus quantum debate

The assessment process proposed under the PAM requires the determination of "*the proportions of the class amounts* [of trust profit defined by ITAA] *to which beneficiaries are presently entitled*".[4] Further, *"the tax liabilities of the trustees and beneficiaries of the trust are determined in accordance with reference to the beneficiaries' present entitlement to shares of relevant class amounts"*.[5]

However, the Policy Options Paper does not prescribe how the ***trust profit*** (divided into classes) is to be allocated to beneficiaries other than to indicate that it will be based on present entitlement – a trust law, and not a tax law, concept.

It is therefore evident that the PAM runs the very real risk of re-igniting, rather than eliminating, the proportionate versus quantum debate. The following example highlights this issue.

The trustee determines, in accordance with its obligations under the trust deed, that the income of the trust estate is to be $100 and appoints that $100 income to Beneficiary A.

The trustee calculates the trust profit (in accordance with the ITAA) which happens to be $150. The trustee also calculates the trust's taxable income which is $175.

Assuming there is only one class of income – is Beneficiary A taxed on:

(a) $100 – being the amount to which they are presently entitled) with the trustee taxed on the remaining $75 of the trust's taxable profit (ie the quantum approach); or

[4] Page 22, Taxing trust income – options for reform
[5] Page 25, Taxing trust income – options for reform

(b) \$117 – being ⅔ of the \$175 taxable income (that is, ⅔ is the proportionate share of \$100 as to \$150) and with the trustee taxed on the remaining \$58 of the trust's taxable income; or

(c) \$175 – as there is only one beneficiary presently entitled to income of the trust estate (ie the proportionate approach).

Conclusion

The proposed definition of 'trust profit' together the PAM assessment process will not achieve the aims of providing certainty and minimising compliance costs and complexity.

Q.6 - Should the Trustee be able to change the classes from year to year? What limits, if any, could be put in place, to prevent unintended consequences?

Determination of Classes

The paper defines 'class' for the purposes of the PAM as a category into which components of the trust profit can be allocated. [6] However, no guidance has been provided as to how the Trustee is required to determine these classes. The only requirement provided is that the allocation must correspond with the actual legal nature of allocated trust profits. [7]

We submit that within the confines of 'actual legal nature' of trust profit the trustee should have the flexibility to determine the relevant class.

For example, class might be determined based on the character of income received, such as interest, franked dividends, unfranked dividends, trading business or rent. Alternatively, class might be based on the source of income – domestic or foreign or simply revenue and capital.

Ability to change Classes

The paper is also silent on whether classes selected in the Trust's first year (or in the first year that the proposed trust reform measures will apply from) can be added to over the remaining life of the Trust.

We are of the view that the allocation of Trust Profit into a class or classes needs to be determined in each financial year as the nature of the Trust's activities will conceivably change over time. As there is a requirement that the allocation of Trust Profit into a particular class is determined by its legal nature we cannot envisage what unintended consequences might arise if a trustee were able to change the classes from year to year.

For example, if a Trust were not allowed to add to or change classes what would happen in the situation where a Trust that had operated a business for a number of years and had allocated its Trust Profit to an 'active business income' class then sold its business and invested the proceeds into passive investments?

What if a class of Trust Profit is a loss?

Once Trust Profit has been allocated to the selected classes no guidance has been provided as to what happens if a particular class is in a loss position. For example, if rental income is

[6] Page 22, Taxing trust income – options for reform (policy options paper October 2012)
[7] Page 24, Taxing trust income – options for reform (policy options paper October 2012)

one of the selected classes and in a particular year derives a net rental loss will this loss be allocated proportionately across the other selected classes of trust profit? Alternatively, will the losses be carried forward to be offset against the same class in subsequent years? In maintaining the main principle of minimising compliance costs and complexity, it would appear the alternative option would not be ideal (particularly if the Trust is in an overall taxable income position).

Conclusion

Trusts are established for a variety of reasons and the nature of activities conducted by Trusts may vary from establishment to their vesting date. Therefore, the nature of trust profit derived during this period may vary from year to year.

If classes selected in year one cannot be changed or added to over the lifetime of the Trust, this will not accommodate the potential changes in the nature of activities conducted by Trusts.

As no unintended consequences can be foreseen in allowing the ability to change classes (particularly as the key requirement is based on legal characteristics), we believe trustees should have the ability to determine the classes of trust profit on a year by year basis.

Q. 7 - Should there be a specific entitlement rule to deal with capital gains?

We agree that there should be a rule within the PAM to deal with capital gains and suggest rather than modifying the existing specific entitlement rule that it be entirely re-written so that it is appropriately tailored for the PAM and takes into account feedback on the existing Sub-Division 115-C that has now been around for approximately eighteen months.

The reason that a specific entitlement rule is required is that the PAM proposes to define 'trust profit' to include gross capital gains but then to allocate this 'trust profit' to beneficiaries based on their present entitlement to 'income of the trust estate'. Without some form of specific entitlement rule, the proposed PAM will not effectively operate as beneficiaries may not be presently entitled to capital for reasons including:

- the capital gain has not yet been recognised in the accounts of the trust as the sale has not yet been realised; or

- the trust deed does not define 'income of the trust estate' to include a capital gain.

One advantage of the existing specific entitlement provisions is that a beneficiary does not have to be presently entitled to a capital gain for reasons such as those set out above. Instead, if a beneficiary has received, or is reasonably expected to receive, a financial benefit that is referable to the capital gain then, provided other relevant conditions are met, this would be sufficient to bring them into the operation of Sub-Division 115-C.

One of these additional conditions is that the beneficiary's entitlement to the financial benefit associated with the capital gain must be recorded in its character in the accounts or records of the trust and within a two month period following year-end. We have two concerns in this area that should be addressed during the reform process.

The ATO have released Tax Determination 2012/11 to confirm that trustees can meet the 'records of the trust' requirement if an appropriately worded resolution is prepared within two months of the year-end in which the contract is signed notwithstanding settlement may not take place at all or it may not take place for some time. We would like to see the ATO's interpretation in TD 2012/11 clarified in the reform legislation.

We are also of the view that the existing requirement to make a beneficiary specifically entitled to a capital gain within a two month period of year-end is unrealistic. Many trustees may not be aware that for capital gains purposes that the date of signing the contract is the trigger for tax liability and not settlement. It is therefore well after balance-date that advisers often identify sales of capital assets that need to be included in the trust's tax return. As such, the two-month time-frame is unrealistic and should be extended until the lodgement date of the trust's tax return.

Q.8 - Should any new model for taxing trust income be treated as an exclusive code? If so, why? If not, to what extent should trust distributions otherwise be taken into account for tax purposes?

We agree that any new model for taxing trust income should be dealt with under one exclusive code. It is therefore our preference that as many issues as possible are considered within the one re-write of Division 6.

Trusts remain one of the fastest growing structures used in commerce in Australia. Their cost effectiveness and flexibility within family groups and across generations will continue to fuel their use. Such use is not driven primarily by income tax planning but by a desire to provide flexibility for the future.

Notwithstanding our comments above, there may be a number of classes of trust that may be potentially carved out of the re-written Division 6 either on the basis that either the initial re-write can deal with the majority of trust structures in the first instance and the remaining minority considered in later re-writes. Alternatively these other classes of trust could be included in a separate taxing regime – such trusts including:

- Bare trusts
- Fixed trusts
- Consolidated trust groups
- Deceased estates & testamentary trusts
- Widely held trusts
- Charitable trusts
- Managed investments trusts

It is preferable that trustees be able to choose to be excluded from the re-written Division 6 and be taxed under specific regimes.

Other amounts of trust profit assessable under divisions other than Division 6.

In addition to CGT Event E4 noted on page 27 of the Policy Options Paper the application of Division 7A is another major area that should be focused on in the re-write of Division 6.

A recent ATO Interpretative Decision (ATO ID 2012/63) highlights the problem faced by unit trusts particularly where tax profit is lower in one year than accounting profit because of timing differences. This very situation should be clarified in CGT Event E4 to confirm that timing differences should not in themselves cause CGT Event E4 to be triggered.

A more greater area of concern relates to the extended operation of Division 7A to unpaid present entitlements arising from the ATO's change in interpretation of these provisions. We are of the belief that significant consideration must be given to the interaction between Division 6 and the non-commercial loan provisions in Division 7A. This Division is one of the most difficult compliance areas for private family groups.

Q.9 Should bare trust type arrangements be excluded from the new model for taxing trust income?

Bare trusts should be excluded so that the tax effect of transactions undertaken is reported and lies where the commercial risk lies. Instead a "look through" approach should be available to the beneficiaries of these trusts. Should the re-write cause current industry practice to no longer be acceptable, specific legislation should be enacted to ensure the "look through" approach is available.

As a flow through, the beneficiaries should bear all the tax obligations associated with the trust's taxable income. To the extent there are amendments to any income years, these should also be with the beneficiaries and any adjustments taken up in the beneficiaries' returns rather than the trustee's return. This approach is consistent with the whole bare trust arrangement.

Trusts which have the following types of beneficiaries should also be able to elect into the "look through" approach in respect of that part of the trusts income and/or capital:

a Fixed income beneficiaries; or

b Fixed capital beneficiaries; or

c Both fixed income and fixed capital beneficiaries

Further provisions should be made such that amendments and alike follow through to the beneficiaries rather than being assessed to the trustee.

Q.10 Are the characteristics of bare trust type arrangements sufficient to describe and possibly define such arrangements?

The first characteristic of a bare trust arrangement on page 28 of the policy options paper refers to "a clearly definable fixed interest". Currently there is great uncertainty as to what is a fixed interest and the current legislative approach is complex. There would need to be clarity on the definition of this term and fixed interest for this characteristic to be workable.

Other than this comment we consider the characteristics of a bare trust arrangement set out on Page 28 and 29 of the Policy options paper are sufficient to describe and define such arrangements.

Q.11 – Should bare trusts be ignored for the purposes of GST? If the extension were not to apply to all bare trust like arrangements, how should they be distinguished?

Bare trusts (and instalment warrants) should be ignored for the purposes of GST consistent with the income tax treatment. However trustees of bare trusts and instalment warrants should be able to elect for this not to be the case. An election should be available on an opt-out basis. This would allow IDPS to continue to have the trustee attend to the GST obligations should they so wish.

Q.12 – The distribution principle has been applied flexibly in the detailed EBM example to enable the difference attributable to the legal expenses to be assessed to the beneficiaries, as this is considered a desirable outcome. While this may be the desired outcome, does the principle as developed actually accommodate this outcome?

(a) Should the principle be modified to deal with such amounts?

(b) How can the principle be modified to deal with such amounts?

(c)What other types of amounts might cause the same problems?

The principle as developed does not seem to accommodate this outcome. It only works equitably where the trust first has received income in excess of its taxable income and sufficient to allow capital distributions in future years where the taxable income may be greater than accounting profits.

The EBM approach does not deal well with tax differences that are legitimate differences such as the case here where an expense borne by the trustee is not deductible (or not immediately deductible) or it is a timing difference that will resolve itself across future tax years. When these circumstances exist, the trustee may not have sufficient trust capital to pay a capital distribution to cover the differential. Further, the income beneficiaries and capital beneficiaries may differ, leading to inconsistency with trust law objectives.

To the extent these differences arise and are not artificially created to achieve a certain tax outcome, the taxation treatment should not be punitive. Such anomalies could be dealt with by enabling the trustee and beneficiary to agree that distributions may be made but held on account for the relevant beneficiary until such time as funds become available.

The proposed EBM approach appears to conclude that to the extent notional amounts or deemed amounts are taxed to the trustee, the trustee will always pay any tax associated with these amounts due to the inability for these amount to be distributed. This is an example of the inequity created by rigidly adhering to a 46.5% trustee tax rate.