General Manager
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Dear Sir/Madam

Response to Treasury Policy Options Paper
Taxing Trust Income – options for reform

AVCAL welcomes the Government's Policy Options Paper – Taxing trust income – options for reform, October 2012 ("Options Paper"), and appreciates the opportunity to make a submission in relation to some of the issues raised in the Options Paper.

The key issues for our constituent members are as follows:

- The application of Division 6 as a code for taxation of trusts will remain important for funds structured as trusts that do not meet the definition of MITs, or which do meet the definition of MITs in some years but fail the requirements to meet the definition in other years. In respect of the latter point, we recommend that legislation be introduced to deal with the interaction between the proposed MIT Tax Regime and Division 6. Legislative certainty to taxpayers is paramount for the reform to operate as intended. The reforms should also aim to improve the operation of the rules for trusts and their beneficiaries where this is possible.

- Our preferred model of taxation is one that allows the proportionate distribution and taxation of the net income of the trust on a classes of income basis ("Proportionate basis"). The current models discussed in the Options Paper require slight modifications to achieve the Proportionate basis.

- A principle based approach to the definition of "trust income" should be adopted. For example, allowing trust income to be defined as s95 net income with adjustments for gross up amounts should be acceptable.

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- Likewise, the allocation of expenses on a "fair and reasonable basis" should only be expressed in the law as a general principle. This should be supported by clear and detailed examples in the explanatory material to the amending bill. Our preference is where there is an additional allocation of "direct" and "indirect" expenses to a class resulting in a loss for that class, then that loss should be treated as an indirect expense for allocation against other classes of income. Where all income is reduced to NIL, the balance (if any) should then be offset against capital gains of the trust (if any) where the trust deed permits this.
- Character and source flow-through to investors is also an important issue for our constituent members. In addition to capital gains and franking credits, character retention and streaming should be extended to all income types, such as capital gains from Taxable Australian Property, foreign income (and foreign tax credits), NANE and exempt income. AVCAL recognises that streaming should be subject to anti-avoidance measures. The introduction of a rule to provide for the retention of character and source will address long standing uncertainty for investors. For the avoidance of doubt, unless paid on or in relation to a carried interest (as defined in Division 275 of the *Income Tax Assessment Act 1936*), the character of distributions of capital gains made from capital assets by trusts should retain their character as capital gains regardless of whether the beneficiary is a revenue account unit holder or a capital account unit holder.

- As noted in the recent workshop with Treasury, it is inappropriate to tax bare trust arrangements such as custodial relationships. Any carve outs should apply to all bare trusts plus an inclusive list of acceptable genuine intermediary arrangements which should be developed in conjunction with the custodial and managed funds industries. A starting point for the definition of bare trusts could be section 106-50 – Absolutely entitled beneficiaries.

- However, from a Goods and Services Tax ("GST") perspective, the law should allow for trustees of bare trusts to register as the responsible entity for GST purposes. We understand that the ATO has issued a number of private rulings allowing trustees of bare trust arrangements such IDPS to register as the responsible GST entity, where it is impractical for individual investors to register and account for GST directly.

- Any amendments should include transitional provisions allowing trustees sufficient time to adapt their systems to comply with the amendments.

- Finally, we understand that the ATO's view is that changes to trust deeds, required as a result of the reforms, would not result in a resettlement of a trust for income tax purposes (refer to recent Clark's case decision). However, as noted at the recent workshop, it would be desirable to provide some legislative support for this, and also for the Government to engage with state governments for them to provide relief from any state tax liabilities.

AVCAL is keen to be an active participant in the consultation process in relation to the taxation of trusts. If you would like to discuss this submission in more detail, please contact Ian Scott on 02 9248 4774 or Tasha Chua on 02 9248 5613 or myself on 02 8243 7000.

Yours sincerely

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