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Dear Sir/Madam

Modernising the taxation of trust income – options for reform - submission on discussion paper

The members of the Australian Custodial Services Association (ACSA) welcome the opportunity to provide this submission to Treasury on the issues raised in the discussion paper on *Modernising the taxation of trust income – options for reform* (Options Paper) that was released in November 2011.

About ACSA

ACSA is the peak industry body representing members of Australia's investment custodial and administration sector. Collectively, the members of ACSA hold securities and investments of approximately AUD $1.85 trillion in value in custody and under administration. Members of ACSA include National Australia Bank Asset Servicing, JP Morgan, HSBC, State Street, RBC Dexia Investor Services, BNP Paribas, Northern Trust and Citigroup.

Summary of ACSA submission

An overview of ACSA's position set out in this submission on the proposed changes to Division 6 is:

- Custody arrangements should not be taxed as separate trusts – an exclusion should be allowed for custody arrangements where the custodian holds assets for

a client pursuant to an Australian financial services licence covering the provision of custodial or depository services for purposes of the *Corporations Act*.

- ACSA does not have a strong preference for any one of the proposed taxing methods. We believe it is for the trusts directly impacted by reforms, and their representative bodies, to put forward recommendations on the preferred method. We strongly resist any method that involves the trustee being subject to tax at the maximum rate on part of a trust's taxable income. Furthermore, there should be an allowance for 'overs and unders' for non-MIT unit trusts (in a manner similar to that developed for MITs).
- The Division 6 changes need to be developed in conjunction with the MIT regime reforms to ensure the two 'codes' interact properly with clarity and simplicity of the respective rules.
- ACSA prefers the second option relating to expense allocation – there should be a general legislative rule providing that expenses should be apportioned on a fair and reasonable basis.
- ACSA would like to see 'character flow through' enshrined in the tax legislation through a general provision with specific exceptions.

Tax treatment of custody arrangements

The income tax treatment of custody arrangements is critical to the Australian investment industry. There are, broadly, 2 approaches that can be taken:

- Do not treat the custody arrangement as a separate trust for Division 6 purposes. Instead, treat income and gains derived (and expenses incurred) by a custodian on behalf of a client as derived/incurred by the client directly. There is no requirement for the custodian to lodge a trust tax return.
- Treat the custody arrangement as a separate trust estate for Division 6 purposes and the trustee/responsible entity (RE) arrangement with fund (superannuation or distributing trust) beneficiaries as a separate trust. A separate trust tax return would need to be lodged by the custodian.

We strongly believe that the first approach should be preferred and confirmed as part of the tax modernisation process for trusts.

There are overwhelming practical and administrative reasons for our preferred approach. The Australian custody industry and their clients – the main group being managed investment trusts (MITs)/other distributing trusts with institutional investors and large APRA regulated superannuation funds – conduct their tax compliance and governance on this basis, so it reflects current practice.

We are not aware of any custodian that lodges a separate tax return disclosing taxable income from investments held for an individual client. Returns are universally prepared

and lodged on the basis that the trustee/RE client of the custodian is entitled to the flow of income and all other benefits and obligations of their investments. Any change would require an additional level of tax calculations and returns with the following consequences:

- Further work and significant costs involved in preparing a custodian return – this would require work by the custodian and work by the custodian's tax agent in verifying and signing off the return and arranging lodgement with the ATO;
- A new level of risks for custodians would need to be reflected in their fee structures and contractual arrangements with clients. The exposure to 'tax risk' with revenue authorities – in the form of primary tax, interest and penalties – would be substantial. This would necessitate development of new tax governance frameworks to meet internal risk requirements of custodians and requirements of regulators.
- Custodians would have to account for PAYG tax obligations. Specific PAYG obligations (or carve outs) would need to be developed.
- Custodians would also need to meet any applicable Australian Investment Income Reporting requirements.
- Issues associated with 'unders and overs' would potentially be intractable. The custodian would need to advise clients of tax components on amounts for which final tax statements had not been received. Estimates would need to be used and there would need to be rules governing the treatment of variances with the final tax amounts. The sort of issues identified in the under and over rules being developed for the MIT reform project are a guide to what might need to be addressed in this context if the decision is made to tax custody arrangements.
- A substantial regulatory response would be required to oversee a new responsibility of custodians. For example, the GS007 auditing requirements would need to be revised.
- The ATO would be required to process the custody return and issue tax assessments to the custodian. This could delay the distribution process for distributing trust clients. Commercial considerations aside, prudent trustees/REs would (hoping to avoid penalties and interest) likely require the ATO's assessment for the custody trust before determining the distribution for unit holders.
- The imposition of an additional tax compliance framework could be perceived as contrary to the principles of regional cost effectiveness and reduction of 'red tape' as espoused by the Johnson Report on the role of Australia as a regional financial services centre.

The current practice of non-lodgement of separate tax returns for custody arrangements is based on the commercial understanding that the custodian has no tax liability for custodial assets. Some support for the practice can be found in the ATO Law Administration Practice Statement PS LA 2000/2, however, the wording of this arrangement is not in our view satisfactory. The notion of a 'transparent trust' is too vague and not cognitive of modern investment practices of custodians. For example, a custodian with clients that own, in aggregate, 100 million BHP shares would typically hold such shares in a single holding on the BHP register under a single CHESS holder identification number (HIN). It is not clear whether this arrangement would be viewed as a 'trust in which *the beneficiary* of the trust estate has an absolute, indefeasible entitlement to the capital and the income of the trust'.

Although technically there is a trust relationship between custodian and client, it is a bare trust. The main source of rights and obligations between the parties is contractual (the custodian agreement and service level agreements). The custodian has no active or autonomous duties or rights. Additional services provided by a custodian such as accounting, tax reporting, unit pricing, valuations, registry, AIIR do not affect the bare trust position.

The feedback provided to ACSA members from custodians in other countries (for example, the United Kingdom and Canada) and their advisers is that the custody relationship is not treated as a separate tax entity.

In the absence of any convincing case being put forward for the separate tax treatment of custody arrangements, ACSA believes the trust tax modernisation project should take the opportunity to make it clear, once and for all, that such arrangements are excluded from Division 6 and associated tax return and filing requirements.

We consider the most appropriate means by which custody arrangements should be excluded from Division 6 would be to focus on the situation where a '*licensed custodian* holds an investment(s) for a client pursuant to a custody licence where the custodian has no active authority in respect of the investment(s)'. In this context, a *licensed custodi*an is the holder of an Australian financial services licence covering provision of custodial or depositary services for purposes of the *Corporations Act.*

Method of taxing trust taxable income

Simplicity, clarity and certainty of the application of the trust taxation rules are the key objectives for ACSA members having the responsibility for calculating and reporting trust distributions to beneficiaries and ensuring the correct withholding of any tax. Whichever option is ultimately adopted, it must be able to provide custodians with the ability to discharge their responsibilities with confidence and without undue risk of penalties and uncertainty.

Before commenting on the suitability of the methods set out in the Paper and the MIT attribution method, there are two critical issues from the perspective of the custodian that should be noted:

- By far the most common scenario for non-MIT unit trusts, is that:
  - They have a single class of unit holders (holding ordinary units);
  - The amount distributed to unit holders is at least equal to the taxable income of the trust[1] (subject to notional amounts included in taxable income such as tax credit gross ups).

  The affairs of such trusts are conducted so that there is no liability for the trustee in respect of the trust's taxable income. The reason is clear – if there is trustee liability, tax is imposed at the maximum rate which raises the following commercial dilemma for trustees:

  - Do they pay tax out of their own reserves (and seek a whole or partial contribution from their custodian)?
  - Do they recover tax from trust assets, thereby effectively imposing the tax on unit holders (many of which will be taxed at low tax rates – for example, superannuation funds)?

- The second issue is where the amounts distributed to unit holders are, because of timing issues, based on an estimate of taxable income of the trust and it transpires that the actual taxable income differs. The 'actual taxable income' would initially be the amount calculated and disclosed in the tax return of the trust. This may vary, however, when 'unders and overs' for the year are factored in or where the ATO reviews taxable income and issues and amended assessment.

  Where an insufficient amount has been distributed to unit holders as a result of these scenarios, with the causes being outside the control of the trustee, we believe the trust should not be penalised in the form of a trustee tax at the maximum rate. There has been a lot of discussion about these issues in the context of MITs at the MIT roundtable sessions and in separate meetings – we believe the factors are similar for non-MIT institutional unit trusts.

ACSA does not think it is appropriate to recommend one of the three proposed options against the others. We believe that recommendations on the preferred approach should be made by the trusts directly affected and their representative bodies. Nevertheless, we make the following observations:

[1] Subject to the second issue below

- None of the options proposed in Chapter 8 presents a clear preferred method for the custodial industry. Each option has its attractions and complications. The 'Proportionate within Class' option appears to potentially be the most complicated;
- The TAD model that 'follows the money' seems conceptually to provide the least complex model for the taxation of trust taxable income. Importantly, this avoids difficult legal concepts such as 'present entitlement' and 'income of the trust estate' which often depends of the exact terms of individual trust deeds and evolving commercial and financial concepts. However, we believe it is unfair for any taxable amount attributed to the trustee to be taxed at the maximum tax rate. We would oppose any such taxing proposal if it was to be put forward by Treasury and would refer to the reasons set out in ACSA's submissions on the MIT regime on trustee penalty tax. If trustee penalty tax is to be imposed on a trust for which a custodian is providing tax reporting there will always be an issue between the trustee and the custodian as to who bears the cost of the penalty.
- Apart from the three proposed options, ACSA believes that the MIT attribution method should also be considered for non-MIT unit trusts. This method taxes beneficiaries on 'taxable income' that the trustee allocates to them on a fair and reasonable basis consistent with their entitlements under the trust deed. The custodial industry views this alternative favourably as ACSA members' systems will be configured to deal with processing and reporting trust distributions under this method, thus minimising the incurring of further time and costs for system upgrades.
- Custodians and their trust clients are already required to calculate accounting profit and taxable income. Introducing a third concept of 'distributable income' should be avoided if it is to require an additional level of calculation.
- ACSA would like to review any further detailed proposals for the taxation of non-MIT trust income once they are developed to provide feedback in the context of practical examples for actual trusts.

Clarifying the treatment of expenses

The Consultation paper sets out 3 options for the allocation of expenses. As a general approach ACSA members prefer that the rules for expense allocation are not overly prescriptive. We note that several of the issues relating to expense allocation are covered by the MIT proposals. The difficult practical issues identified in the MIT reforms (for example, allocation against notional income, allocation against different classes of units) are equally applicable to non-MIT institutional unit trusts. Therefore, we believe

that the rules developed for MITs should be equally applicable to non-MIT institutional unit trusts.

As administrators of trust funds, ACSA would like to see reforms which are:

- Simple;
- Easy to implement;
- Do not require significant changes to our current systems;
- Do not require continual amendments to systems in the future;
- Consistently applied to all trust types, to the extent that policy objectives permit;
- Are developed in conjunction with the character flow-through provisions so that the categories/components of income and capital are consistent.

ACSA sets out its comments on the specific options as follows:

Option 1 – the introduction of specific legislative rules that prescriptively govern the treatment of expenses, including allocation of expenses against different classes of income

- Prescriptive rules are inflexible. Consequently, they will likely require continual amendment where new classes of income are introduced or where government changes its view about how particular expenses are to be treated;
- Single standard rules which attempt to capture all expenses and all income classes are likely to be complex – where such rules need to be applied to all clients, we anticipate complexity because policies and instructions differ between clients;
- From a systems upgrade perspective (linked to costs) we are concerned that amendment to rules which are prescriptive would require continual systems changes;
- There is a higher risk that all items and scenarios intended to fall within the rules are not captured;
- Multi class funds are likely to require more complex rules; how will the prescriptive rule cater for multi class allocations?
- Currently there are no specific expense allocation rules within the legislative framework for other entity types. If a mischief is perceived to be occurring in particular circumstances for particular trusts, could this be dealt with through the general anti avoidance rules or enhancement to the same?
- If the rules are open to several interpretations, there are no real advantages of this option;

Option 2 – the introduction of a general legislative rule to codify the existing common law principle that expenses should be apportioned on a "fair and reasonable" basis. Trust deeds would be unable to override the legislative rule.

- Across the custody industry the current approach is to allocate expenses to classes of income on a "fair and reasonable" basis. Systems are already set up to cater for allocation of expenses in this way and we would prefer that no or minimal changes are required to current system set up;
- "Fair and reasonable" rules can be applied to multi class funds. However, we consider the rules and scenarios for multi class funds should receive specific attention. This issue has been raised in the MIT reforms and we believe the approach should be similar for non-MIT institutional unit trusts. ACSA would be very happy to provide scenarios for consideration;
- Legislative rule to codify current treatment results in further certainty – ultimately this reduces compliance costs and better manages risk for our clients;
- We prefer this option.

Option 3 – no legislative rule, status quo

- As above with Option 2, current treatment is to allocate expenses to classes of income on a "fair and reasonable" basis. Systems are already set up to cater for allocation of expenses in this way;
- "Fair and reasonable" rules can be applied to multi class funds;
- Current treatment appears to be working effectively, although there does not appear to have been any review by the ATO of any scale;
- all mischief caused by not having a carve out for trust deeds seeking to override a "reasonable and fair" allocation of expenses may not be covered by general anti avoidance rules. This could be dealt with by introducing a specific rule for the circumstances which are considered to go against policy objectives.

We prefer Option 2 to this Option as it removes uncertainty for custodians and our clients. Discussions with the external tax specialists that review and sign off on the tax policy manuals of custodians indicate this is an area of uncertainty and therefore a basic statutory basis would underpin the approaches taken.

Providing certainty about character flow-through and streaming

ACSA agrees broadly with the analysis set out in section 3.5 of the Options Paper of the current understanding and practice of the investment industry regarding character flow through for trust distributions. We also agree the statutory endorsement of this understanding is not certain. We recognise that 'streaming' has long been an issue for trusts under our existing tax framework – that has in part been addressed by the recent introduction of streaming provisions in TLAA No. 5 2011.

A critical issue for ACSA members and our clients is the reliance we place on tax statements and component information to facilitate the flow through of tax attributes to ultimate beneficial owners. Central to this whole system is the ATO/FSC Standard

Distribution Statement, as it applies to managed funds. It is imperative that unit holding trusts be able to rely on component (classification and amount) information set out in SDSs and other trust tax statements so they can calculate their own taxable income and flow through information to their unit holders.

We believe the SDS should be mandatory for any trust that has any unit holders that are MITs or non-MIT institutional unit trusts.

In fact, *automation* of the processing of component data for custodians systems would in our view be a huge step for our industry and our clients. A legislative and regulatory framework that facilitates, and even encourages, automation of the component processing function would be a genuine boost to the efficiency of the industry and would not only improve the quality of tax information reported and relied upon by unit holders but also mitigate risks associated with manual processing.

In response to the two approaches set out in section 7.3 of the Options Paper, we believe the preferred drafting approach to recognition of character flow is the generic approach with specific exclusions. This is in our view the most simple approach and will more readily facilitate the integration of future components as they are announced by Government.

The alternative – a prescriptive codification of components of income that could be flowed through - would require continual amendment as and when new components have to be disclosed due to new tax treatments being imposed. This would pressure the legislation drafters and the legislature to identify the need for new components. Inevitably, with scarcity of drafting resources and competing priorities for proper legislative guidance on new or revised components could be overlooked.

We also believe that the character of income flowed through should be the net income after allocation of expenses and losses, consistent with the current practice. Carry forward revenue losses are currently treated in the same manner as expenses in terms of offsetting against components of income, with the exception that losses are offset against exempt income first. The ability to flow through residual components after expense and loss allocation should not be changed.

There are important flow considerations for non-resident withholding tax purposes.

- Withholding tax provisions can only be effectively applied to trust distributions where there is a flow through of components. Australian sourced income needs to be identifiable for this purpose.
- The alternative of flowing through gross components of income and gross losses would result in an unworkable outcome for withholding tax purposes

Interaction of Division 6 with the MIT regime provisions

There are some serious challenges in designing the legislative framework to give effect to the project's reforms. The interaction of this framework and the framework to give effect to the MIT tax reforms is of particular interest to ACSA.

As stakeholders who will be applying the rules set out in each framework to:

- Process the tax effect of corporate actions on the investments of clients and of the acquisitions/realisations of such investments;
- Produce tax reports for clients;
- Design systems and procedures that will either automate or facilitate manual processing of tax data and production of tax reporting,

ACSA members believe we have a key interest in making sure the legislative framework allows, as far as practicable:

- Simplicity and clarity of interpretation;
- Minimum inconsistent results between the two frameworks (for example, in the tax results for identical investments held by a MIT and held by a non-MIT institutional unit trust).

ACSA would like to reserve the opportunity to comment on these interaction issues once the exposure drafts of the MIT regime and the new Division 6 regime have been developed and released. In particular, we will be 'road testing' the two frameworks to assess usability and consistency.

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If you would like to discuss this letter and ACSA's position on the MIT reforms and other tax reforms please contact the Chairman of ACSA's Tax Working Group, Mick Giddings on (03) 8641 0898.

Yours sincerely

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