The AUSTRALIAN PRIVATE EQUITY & VENTURE CAPITAL ASSOCIATION Limited

10 February 2012

The General Manager
Business Tax Division
The Treasury
Langton Crescent
Parkes ACT 2600

Dear Sir or Madam

Response to Treasury Consultation Paper November 2011
Modernising the taxation of trust income – options for reform

AVCAL welcomes the Government's Consultation Paper, released in November 2011, on modernising the taxation of trust income (the "Consultation Paper") and appreciates the opportunity to make a submission in relation to some of the issues raised in the Consultation Paper.

AVCAL notes that in addition to the proposed implementation of a new tax system of managed investment trusts (refer to Treasury Consultation Paper October 2010 – *Implementation of a new tax system of managed investment trusts* ("MIT Tax Regime"), the taxation of trusts remain a key concern for AVCAL's constituent members, particularly for fund structures which include trusts which do not meet the current definition of 'Managed Investment Trusts' ("MIT") for the purposes of subdivision 12-H of Schedule 1 of the *Taxation Administration Act 1953* (and as modified by Division 275 of the *Income Tax Assessment Act 1997*.

We agree that the issues identified by Treasury at point 1.3 of the Consultation Paper require immediate reform. Whilst it was noted in the Consultation Paper that the legislative definition of 'fixed trust' will be examined through a separate process, AVCAL believes that any reform of the taxation of trusts would be incomplete without certainty around the classification of a trust as a fixed trust. As such, we believe that consideration of the definition of 'fixed trusts' should be given equal priority and be considered in conjunction with the other matters identified at point 1.3. This is in light of the comments made by the Federal Court in recent case law (*Colonial First State Investments Ltd v Commissioner of Taxation* [2011] FCA 16) and the Australian Taxation Office that very few trusts would satisfy the current definition of fixed trusts in section 272-65 of Schedule 2F of the *Income Tax Assessment Act 1936*.

In addition to the questions we have provided submissions on in the Appendix, we note that the key issues that our constituent members are facing as follows:

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- 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.

- The issue of whether a trust will constitute a 'fixed trust' is particularly relevant to the venture capital and private equity industry given the linkage to other related provisions such as the trust loss rules, capital gains and losses rules for non-residents and dividend imputation rules.

- Character and source flow-through to investors is also an important issue for our constituent members. 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.

We attach a copy of our submission dated 16 November 2010 on Treasury's Discussion Paper – Implementation of a new tax system of managed investment trusts October 2010, which provides a detailed discussion on the above issues.

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 in the first instance on 02 9248 4774 or myself on 02 8243 7000.

Yours sincerely

Katherine Woodthorpe
CEO

Enc. *Copy of letter dated 16 November 2010 on Treasury's Discussion Paper – Implementation of a new tax system of managed investment trusts October 2010*

Appendix

Modernising the taxation of trust income – options for reform

DISCUSSION PAPER RELEASED ON 21 November 2011

The following sets out AVCAL's submission on the consultation paper 'Modernising the taxation of trust income – options for reform' (the "Consultation Paper"), including a brief description of, and the rationale for, suggested amendments which are necessary in order to make the measures operate in a manner that does not increase uncertainty, complexity and compliance costs for AVCAL's constituent members.

Question 4: Uncertainty about the scope of Division 6 is arguably one of the key issues hampering the effective taxation of trust income. If the scope of Division 6 is clarified, under either an inclusion or exclusion approach, should a general principle or a comprehensive list be adopted?

We believe that Division 6 should remain as a code for the taxation of trusts. However specific exclusions should be included to address the issues of multiple provisions applying to tax the same income. To provide clarity and certainty in the law, the preferred approach should involve the inclusion of a comprehensive list of types of entities that should be excluded from the operation of Division 6. This list may be supplemented by a regulation power to add types of excluded entities to ensure that the list is kept up to date.

Question 5: What types of trust might it be appropriate to carve out of the operation of Division 6? Are there any other areas of the tax law where a similar carve out for these types of trust may or may not be appropriate?

We envisage that trusts which meet the definition of MITs for the purposes of the proposed MIT Tax Regime should be excluded. However, to the extent that qualification for the MIT Tax Regime is based on an annual test, we recommend that legislation be introduced to deal with the interaction between the MIT Tax Regime and Division 6 where trusts move in and out of the MIT rules.

Further, nominee and custodial arrangements should also be excluded from the operation of Division 6. Such types of arrangements are generally referred to as 'bare trust' arrangements, where the 'beneficiary' i.e. the client/beneficiary of the nominee and custodian has both an economic interest in the assets and sole discretion to decide what assets are acquired or disposed of except where there are prior written instructions as stipulated in the nominee/custody agreement.

Typically such arrangements serve an administrative function for the holding of securities and achieving associated economies of scale for its maintenance such as receipt of communications, and as such should be excluded from the operation of Division 6.

Inappropriate outcomes can arise when such arrangements are recognised as trusts. For example, expenses incurred by nominee/custodian on behalf of their client may result in losses that would under the current law be inadvertently trapped at the level of such arrangements instead of being recognised at the level of the true economic beneficiary. Unwarranted additional compliance costs, such as having to lodge tax returns, would also arise if such arrangements are inappropriately recognised as trusts for the purposes of Division 6. Historically, fund managers have been relying on a dispensation provided by the Commissioner to lodge income tax returns for such arrangements (as set out in Law Administration Practice Statement PS LA 2000/2). However, the recent comments made by the ATO in their decision impact statement in respect of the *Colonial First State* case indicates the ATO's view that the current Division 6 could apply to such arrangements and that the ATO is considering amending their practice statement to require that returns be lodged where application of Division 6 results in an assessment of the trustee under sections 98, 99 or 99A.

Whilst, there is recognition of such arrangements in the Tax Law under section 106-50 of the Income Tax Assessment Act 1997, which deals with absolutely entitled beneficiaries, we note that there are still complications with this section as highlighted by the ATO's still to be finalised ruling Draft Taxation Ruling TR2004/D25 (published in December 2004).

We would also recommend that legislation be introduced to provide certainty around the transparent treatment of investments held by such nominee and custodian arrangements, such that income/gains and deduction/expenses are recognised at the level of the client/beneficiary.

Question 8: Should character flow-through and 'streaming' be provided on a general basis with specific limitations or alternatively through the use of specific provisions? If 'streaming' is provided using specific provisions, in addition to capital gains and franked distributions what other types of income should be afforded this treatment?

AVCAL, in principle, supports the proposal for legislating character and source flow-through. The introduction of a rule to provide for the retention of character and source will address long standing uncertainty for beneficiaries in trusts. We see this as the codification of the consistent approach adopted by the High Court (in *Colonial First State Investments Ltd v Commissioner of Taxation* and *Charles v Federal Commissioner of Taxation* (1954) 90 CLR 598).

Other types of income that should be afforded this treatment include foreign sourced income and capital gains from the disposal of non-Taxable Australian Property.

We note that Government has introduced specific provisions in *Tax Laws Amendment (2011 Measures No. 5) Act 2011*. The experience with this new legislation is that it is overly cumbersome and difficult to understand. In this regard, our preference that character and source retention be confirmed as a general principle with examples in a note to the provision and/or the accompanying explanatory memorandum.

Question 12: Should there be one generic or multiple targeted tax regimes for the taxation of trust income? If a generic regime is desirable, which of the three approaches outlined in Chapter 8 should be adopted? Are there any other models that could be considered in updating the operation of Division 6?

Question 13: If a 'proportionate within class' model was adopted would it be necessary to define the concept of distributable income in the same ways as outlined under the 'patch' model?

AVCAL's preferred approach is the 'proportionate within class models'. We agree that this model would be the 'path of least resistance' as this approach is consistent with the way most fund managers and tax professionals have interpreted the current provisions. The introduction of this model would also provide a simpler basis for determining character and source retention.

Question 16: If significant changes are made to the current operation of Division 6 what transitional measures do you consider the Government may need to provide?

Trusts structures have become the investment vehicle of choice by the funds management industry and has been employed by other industry sectors. The issues raised in the Consultation Paper are complex and will have an impact on a large number of stakeholders. Members of the industry will require sufficient time to consider the changes. Therefore we would propose a mandatory start date of no earlier than 1 July 2014, with an election to apply the rules earlier from 1 July 2013 for those trustees that are able to adapt their systems and internal processes to apply the rules from the earlier date.

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