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Submission Re: Minor Amendments to the Capital Gains Tax Law Proposals Paper

The following is Equity Trustees Ltd's submission in respect of the Consultation Paper issued June 2012 entitled 'Minor Amendments to the Capital Gains Tax Law'.

Introductory Comments

Equity Trustees Ltd welcomes the opportunity to comment in this consultation process. Our core business covers the taxation of deceased estates, testamentary trusts and fixed trusts, therefore our focus is on topic 3.1 'Amendments to CGT Event K3'. We wish to provide comment on the proposed treatment, practical issues that may arise, as well as policy intent of the CGT event K3.

The opportunity to review CGT event K3 should address inconsistencies within the current taxation system by excluding charitable funds and income tax exempt funds from its scope.

CGT event K3 does not differentiate between superannuation funds, non-residents, and charitable funds and income tax exempt funds. This is in contrast to the treatment of these entities within the taxation system in general.

A taxing event on philanthropic giving via event K3 is an inconsistency that should be rectified. Taxation policy should reflect social policy whereby philanthropic giving is encouraged rather than penalised.

In our submission the creation of a charitable trust under a will should not attract CGT. The current and proposed position (whether or not based on a correct interpretation of the law):

- Reduces the capital available to generate income for charity,

- Deters people from creating charitable trusts for fear of adverse tax implications.
- Increases legal and accounting costs by encouraging people to establish Private Ancillary Funds *inter vivos* as vehicles for testamentary charitable bequests to circumvent the operation of the existing law (PAFs generally involve establishment and ongoing management and audit costs, which are justified in the context of a tax deduction being available for contributions made to them, but are inappropriate for testamentary trusts where no tax deduction is granted).
- Unfairly prejudices residuary beneficiaries of estates in which charitable trusts are created, or dispositions to charitable but non-DGR beneficiaries are made, by making CGT payable from estate residue where the residuary beneficiaries have no entitlement with respect to the capital giving rise to the gain. This is particularly invidious as many wills governing the distribution of present and future estates will have been prepared and executed prior to the introduction of capital gains tax (or event k3), thus giving this *prima facie* inequitable allocation of a tax liability a *quasi* retrospective impact.

Existing Operation of s.104-215

Section 104-215 ITAA 1997 provides that CGT event K3 happens if you die and a CGT asset you owned just before dying passes to a beneficiary in your estate who:
(a) is an exempt entity; or
(b) is the trustee of a complying superannuation entity; or
(c) is a foreign resident.

At a threshold level there is serious doubt about the characterisation of a *testamentary charitable trust* as a *beneficiary* of an estate for the purposes of s.104-215 ITAA 1997.

The Commissioner has been inconsistent in approach to this subject:

- **PR 20677 includes the following**:

  "2. Will CGT event K3 under section 104-215 of the ITAA 1997 happen where residual assets of the deceased estate are held in trust in perpetuity for the benefit (application of income) of a charity?

  No, CGT event K3 will not happen. This is because in this circumstance the assets will not 'pass' to a beneficiary in the rulee's estate, which is a precondition for the operation of subsection 104-215(1) of the ITAA 1997."

- **In apparent contradiction, ID 2004/458 includes the following:**

  "Issue

  Does CGT event K3 in section 104-215 of the Income Tax Assessment Act 1997 (ITAA 1997) happen if assets, owned by a deceased person at the date of their death, pass to a trust established under their will which is an exempt entity and, under the terms of the trust, the assets are to be held in the trust in perpetuity with the trust income to be applied for public charitable

purposes?

Decision

Yes. CGT event K3 happens if assets owned by a deceased person at the date of their death pass to a beneficiary in their estate that is an exempt entity when the assets pass. In the circumstances of this case, the testamentary trust is a beneficiary of the estate."

(Underlines added)

Typically (subject of course to the terms of the relevant will) where a testamentary charitable trust is created, the capital of the estate is held perpetually for the purposes of charity- as such there is no capital beneficiary, there are only income beneficiaries (discretionary or otherwise). That is to say, the capital is held on trust and "*not passed to a beneficiary*". The contrary view, which underlies the ID 2004/458 treatment of deceased estate assets held on perpetual charitable trust created under a will, is arguably inconsistent with the High Court's decision in Easterbrook v Young (1977) 136 CLR 308.

See also paragraph 5 of IT 2622 which clearly evidences an understanding that assets of testamentary trusts have not been distributed to beneficiaries, but continue to be held, albeit it in a different capacity, initially by executors and then usually by the same people (entity) as trustees (underline added):

> *"Even where a will does not envisage the creation of a testamentary trust, the executor must assume a trustee's fiduciary capacity for some period after death. The responsibilities of the executor are similar to, though legally separate and distinct from, those of a testamentary trustee. The estate represents a legal entity or relationship quite separate from the testamentary trust. In practice it is only in rare cases that two different persons assume the roles of executor and testamentary trustee and, for income tax purposes, the estate and the testamentary trust are treated as one and the same. In fact, the term "trustee" is defined in subsection 6(1) of the Income Tax Assessment Act 1936 ("the Act") to include persons acting as executors or administrators."*

That a testamentary trust is not correctly described as a beneficiary can be neatly exemplified by the following

A. A will directs that the residue of an estate be held on trust for 20 years from the date of death with the income to be paid to XYZ, following which the capital is to be distributed to ABC.

   In this example:
   - XYZ is the incomes beneficiary of the estate, and
   - ABC is the capital beneficiary.

B. A will directs that the residue of the estate be held on trust in perpetuity and the income be paid to XYZ.

   In this example:

- XYZ is the income beneficiary, and
- there is no capital beneficiary.

Going further, and putting to one side issues of perpetuity and the operation of the doctrine of *cy-pres*, if neither XYZ nor ABC were to exist the gifts under the wills would fail- because the trust is not a "beneficiary" in and of itself.

The fact that the doctrine of *cy-pres* may enable the preservation a charitable trust by a court, or in certain circumstances the Attorneys General of the states, substituting another entity or purpose as the charitable object of the trust is not material, and indeed supports the need for an object or purposes separate to the trust itself to be the beneficiary of the trust income for the trust not to fail.

If this analysis is correct then, in adopting the ID 2004/458 approach over the PR20677 approach, the Commissioner has been misapplying 104-215 to testamentary charitable trusts, as the retention of an asset in a perpetual charitable trust under the terms of a will does not satisfy the requirement of an "*asset passing to a beneficiary*" to trigger the operation of the section.

This Review:

Irrespective of whether the Commissioner's past treatment of testamentary charitable trusts under 104-215 is correct at law; this review provides an opportunity for a key policy misdirection to be corrected.

To be endorsed as a *tax concession charity*, or an *income tax exempt fund*, a testamentary charitable trust must satisfy strict criteria, ensuring that the income distributions from the trust are for the benefit of charitable objects (within the technical legal meaning) or Deductible Gift Recipients respectively. It is anathema that deceased estates which preserve capital for the purposes of generating income for such purposes should be subject to event K3.

CGT Event K3 – Proposed Treatment Practical Issues

The consultation paper states that under this proposal, the tax liability will lie with the relevant entity (such as the LPR or testamentary trustee) that passes the asset to the concessionally taxed entity, rather than resting with the beneficiary.

Even if it is correct to characterise the trust as a beneficiary to which assets pass, providing that the tax liability will not rest with the beneficiary, is clearly inconsistent with tax policy generally whereby deceased estates and testamentary trusts act as a pass-through entity whereby tax assessments are felt by all beneficiaries either directly or indirectly.

An example:

- According to the will of John Smith, a trust to be known as the John Smith Charitable Trust is created, whereby the listed shares held by John Smith at his death are to be held in perpetuity with the income to be applied for the benefit of XYZ (a purpose or institution charitable at law and quite possibly a Deductible Gift Recipient).
- John Smith's children are to share in the balance of the estate equally.

- John Smith Charitable Trust is endorsed as a Charitable Fund by the Australian Taxation Office (ATO).
- Estate administration ends and the shares held at date of death are retained by the Executor who now acts as trustee of the John Smith Charitable Trust.
- According to the proposed treatment, CGT Event K3 occurs and is assessable to the Estate.
- The Estate is obliged to pay the CGT from the estate residue to which his children are entitled.
- This will have unintended consequences for the children of John Smith who will in effect pay the CGT on capital gains to which they have no entitlement
- This unintended consequence of charitable provision in wills will apply to wills written long ago of persons still living (who may or may not retain testamentary capacity to amend their wills), without K3 implications having been considered.

It is plainly unjust that the residuary beneficiaries of such wills should be prejudiced by this unintended and inequitable tax consequence of the testator's charitable designs.

By suggesting the tax liability lies with the passing entity CGT event K3 will not apply the principles of present entitlement whereby a resident beneficiary is liable to tax in respect of a part of net income if the beneficiary is presently entitled to a share of the 'income of the trust estate' and not under a legal disability.

Whilst the paper looks to simplify the assessing and taxing CGT event K3, we query the how the treatment of the capital gain in the hands of the Estate/Testamentary Trust intends to address the outcomes as outlined above.

CGT Event K3 – Meaning of Exempt Entity

The meaning of 'exempt entity' in s.104-215 (1) (a) ITAA 1997 is qualified through Section 118-60 ITAA 1997 by stating that the 'exempt entity' condition has one exception whereby a capital gain or loss made from a testamentary gift of property that would have been otherwise been deductible if it had not been a testamentary gift is disregarded. Effectively assets passing to an entity endorsed as a Deductible Gift Receipt (DGR) do not incur CGT event K3.

Unfortunately, CGT event K3 does apply to entities such as:

- A Charitable Fund endorsed by the ATO as being a fund established under an instrument of trust or a will for a charitable purpose.

- An Income Tax Exempt Fund registered by the ATO is a non-charitable fund that distributes money, property or benefits solely to DGRs.

Charitable funds and income tax exempt funds are currently required to go through assessment by the ATO in order to achieve status as a concessionally taxed entity. The fact that they do not have the same status as a DGR in terms of CGT event K3 defies any reasonable application of policy.

A clear example of this is an endorsed Income Tax Exempt Fund. It exists only to distribute funds solely to DGR's. Under normal circumstances, the taxation system allows a deduction for giving funds to a DGR. Under CGT event K3 it takes the

opposing position of applying the K3 taxing event to funds retained in an ITEF testamentary trust thus giving rise to a taxing event.

We suggest that either:

- **sub-section 1(a) should be removed from section 104-215 ITAA 1997 ('is an exempt entity'), or**

- **the s.118-60 exemption should be expanded to include funds entitled to be endorsed as Charitable Funds or Income Tax Exempt Funds**

(noting however that the latter approach will further entrench the existing anomaly whereby testamentary charitable trusts with both charitable beneficiaries or purposes which are not DGRs and non-charitable DGR beneficiaries (for example public hospitals) fall between the gaps in endorsement criteria due to the expansive interpretation of the supposed "connection to government" exclusion from the definition of "charitable" which presently has currency in Australia.

Whatever the mechanism, exempting testamentary charitable trust from CGT event K3 would lead to fairer outcomes, be easier to administer for trustees and tax practitioners, and harmonise k3 with other aspects of Tax law which operate to encourage (or at least not discourage) charitable giving, whilst retaining the policy intent of the CGT event.

Conclusion

The 2011-12 federal budget stated that the amendments were to ensure the proper functioning of the capital gains tax provisions this measure will have a negligible revenue impact. From this, the opportunity to create a clear and fair position around CGT event K3 should not be missed.

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