FSC FINANCIAL SERVICES COUNCIL

10 February 2012

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

Dear Mr Daw

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

The Financial Services Council ("FSC") welcomes the opportunity to provide a submission on the above consultation paper. This submission is provided in response to the invitation issued by the Government inviting submissions on the issues raised in this consultation paper.

The FSC represents Australia's retail and wholesale funds management businesses, superannuation funds, life insurers and financial advisory networks. The FSC has 128 members who are responsible for investing $1.8 trillion on behalf of more than 11 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Stock Exchange and is the fourth largest pool of managed funds in the world. The FSC promotes best practice for the financial services industry by setting mandatory Standards for its members and providing Guidance Notes to assist in operational efficiency.

It is important that there be an effective system which allows collective investment vehicles such as unit trusts which fall outside the New Managed Investment Trust Regime to retain the tax status which these entities presently enjoy under the existing provisions of Division 6 of the *Income Tax Assessment Act 1936*. The existing regime provides that that each component of the unit trust's income including capital gains retains its character on distribution to unit holders for tax purposes. For example, amounts representing capital gains, tax deferred income, dividends (including attached tax offsets on distributions) or interest, flow through the unit trust and retain their character for tax purposes in the hands of unit holders. Similarly, it is undesirable for any changes emerging from this process to have an effect on the existing non-resident withholding tax regime and the elective capital gains tax regime.

The FSC submits that the successor regime of Division 6 should contain the concept of a fixed trust which would include collective investment vehicles, such as unit trusts. This successor regime should contain rules governing the taxation of unit trusts which meet

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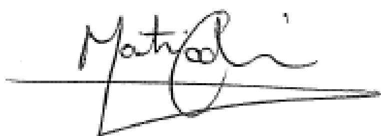
the requirements of the fixed trust definition. This proposed regime is more fully outlined below. Essentially, the taxation regime proposed for unit trusts would be in line with the existing taxation regime for fixed trusts contained in Division 6.

We thank you for the opportunity to submit on this important topic and invite any further enquiries which might lead to developing a robust and administratively workable solution to the taxation of unit trusts which fall outside the Investment Manager Regime.

If you have any questions regarding the FSC's submission, please do not hesitate to contact Blake Briggs or myself on (02) 8235 2566.

Yours sincerely



MARTIN CODINA
Director of Policy

The FSC provides the following answers to the "Questions for Consultation" outlined on Page 43 of the Consultation Paper.

1. Do the policy principles outlined in Chapter 1 accurately reflect the existing framework for the taxation of trusts?

   The FSC in principle agrees with the policy principles outlined in Chapter 1, however, the following comments should be made:

   - The first principle

     The first principle may be interpreted in a way that requires trusts to distribute money in order to avoid tax being imposed on the trustee. In this respect, the use of the word "*receive*" does not assist. The principle would be better expressed as follows:

     "Tax liabilities should attach to the entities that are entitled to the economic benefits from the trust."

2. The Government has identified a number of areas of the trust income tax provisions that require immediate reform. Are these the areas in most need of immediate reform? If not, what areas should the Government seek to reform as a priority?

   The FSC is of the view that the paper focuses most of its attention on areas of trust tax law that are not entirely defective. An area which we believe particularly requires attention is the definitions of 'fixed trust' and 'fixed entitlement' in ITAA 1936 Sch 2F, Div 272. These definitions affect the operation of provisions such as the CGT discount rules (Div 115), the 45-day rule, the tracing rules for corporate losses (Div 165), the scrip for scrip rules (s124-781) , the closely-held trust rules (Div 6D) etc.

   The issues that arise in this regard seem to be ATO administrative practices developed over the years. In the absence of any indication that the ATO will change its practice, legislative rectification is required.

3. Should the trust income tax provisions be updated and rewritten as part of a single process or would it be more appropriate to conduct this reform through a staged approach?

   The FSC favours a single process, rather than a staged approach. The staged process would introduce unnecessary complexity.

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?

The FSC favours Division 6 being drafted as a general regime for the taxation of trusts with specific provisions for fixed trusts as defined and residual rules for the taxation of discretionary trusts. The FSC envisages that unit trusts which are collective investment vehicles would be taxed under the fixed trust regime of Division 6 where the relevant unit trust does not meet the qualifying requirements of the Managed Investment Trust Regime.

Certain investment vehicles should also be expressly excluded from the Division 6 provisions. These are more fully discussed in the answer to Question 5 below.

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 suggest that the following Trust arrangements be expressly excluded from the operation of Division 6:

- Bare Trusts. The qualifying requirements of bare trusts are presently being debated by all interested parties. It is submitted that qualifying bare trusts should be taxed under the general provisions of the *Income Tax Assessment Act 1997*, as modified by specific rules applicable to bare trusts, such as Section 106-50;

- Custodian arrangements. These arrangements should be specifically excluded from the operation of Division 6 and taxed under the same rules as bare trusts. See above;

- Investor Directed Portfolio Services. These arrangements should be taxed on a "look through basis." with income and deduction entitlements (including losses) flowing to the relevant investor;

- Trusts taxed under the Managed Investment Trust Regime;

- Trusts taxed under 6C of the *Income Tax Assessment Act 1936*;

- Superannuation entities that are constituted as trusts.

6. Is there sufficient uncertainty with the current treatment of expenses to warrant a legislative solution?

The FSC is of the opinion that the allocation of expenses should be determined by the Trust Deed. In the absence of specific expense allocation provisions within the trust deed, expenses should be allocated on a 'fair and reasonable' basis.

The above principle reflects the fiduciary obligation of the Trustee to treat all unitholders of the same class of unit equally and unitholders of different classes (i.e. multiple class unit trusts) fairly.

Any ‘uncertainty’ is largely a product of the difference in opinion between what the Australian Taxation Office and the relevant Trustee considers is a ‘fair and reasonable’ allocation of expenses. The FSC is of the opinion that any legislative solution should reflect a broad policy principle of a ‘fair and reasonable’ allocation of expenses rather than any prescription allocation basis.

7. If the concept of distributable income is to be defined using tax concepts, what adjustment will need to be made to existing tax concepts to allow for a workable definition?

   The FSC does not favour a legislative definition of distributable income using tax concepts. There will always be timing differences creating a difference between taxable income and distributable income. In the case of a Fixed Trust as defined under the new regime, the trust deed would contain rules relating to the calculation of distributable income and its apportionment amongst unit holders.

   For tax purposes the income tax liability should be pro- rated amongst unit holders in receipt of income in accordance with provisions in the trust deed, which could provide for streaming. Similarly, the capital gains tax liability should be pro-rated amongst unit holders entitled to capital. The allocation of tax liabilities would be governed by the terms of the trust deed. The Regime should allow fixed trusts to allocate tax liabilities in accordance with the provisions of their trust deeds.

   It is submitted that the fixed trust regime should also contain rules dealing with over and understatement of tax liabilities consistent with those of the Managed Investment Trust Regime.

   Also, in relation to ‘overs and unders’, cost based adjustments under the attribution method should be considered.

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?

   The FSC submits that character flow-through should be provided on a general basis rather than through the use of specific provisions. This would accord with the current treatment applying to the taxation of trust distributions.

   The prevailing law in respect of trust distributions supports the conduit approach. This was first articulated by the High Court in *Charles v Federal Commissioner of Taxation (1954) 90 CLR 598*. Subsequent case law has, in our view, not overturned this case. *Charles’ Case* remains authority for the principle that income received by a trust retains its character in the hands of all beneficiaries, including those whose units are treated as being on revenue account on disposal. Recently, the AAT expressly reaffirmed the conduit theory in *Greenhatch v FCT (2011) AATA 479*. In that case the ATO sought to argue that the conduit theory was no longer sound law and based their argument on selected extracts from cases such as *CPT Custodian Pty Ltd v Commissioner of State*

Revenue (2005) 224 CLR 98. These arguments were rejected by the AAT, where it was specifically stated that:

> "*In CPT Custodian the High Court did not overrule the decision in Charles and where there is a straightforward trust, or a trust where who is entitled to what is clear, there is no reason to suggest that the significant conclusion in Charles is not applicable as a guiding principle."*

Additionally, the FSC submits that "streaming" should also be provided on a general basis rather than through the use of specific provisions.

Prior to the decision in *Federal Commissioner of Taxation v Bamford (2010) HCA 10; 240 CLR 481*, the tax law treatment of streaming capital gains and franked distributions was well understood. The proposition that streaming was possible (subject to the terms of the applicable trust deed) was supported by the Australian Taxation Office (ATO) in Taxation Ruling TR 92/13.

However, the ATO has interpreted the "proportionate approach" advocated by the High Court in *Bamford* as resulting in it being impossible for trusts to stream different classes of income to different beneficiaries as previously allowed (Decision Impact Statement and Practice Statement PS LA 2010/1). Legislation was then introduced to effectively reinstate the original "understanding" of the availability of streaming capital gains and franked distributions (*Tax Laws Amendment (2011 Measures No.5) Act 2011*). Accordingly, the current "specific provisions" to allow streaming have resulted from the ATO's interpretation of the proportionate approach adopted in *Bamford* as precluding streaming.

However, the proportionate approach has been applied prior to the decision in *Bamford*, for example in the Federal Court decision in *Zeta Force Pty Ltd v FCT (1998) 39 ATR 277*. As streaming was recognised as a general principle irrespective of the proportionate approach prior to *Bamford*, we submit that "streaming" can be achieved on a general basis rather than requiring specific provisions.

9. How should losses be dealt with where character flow-through of different classes of income is recognised?

   Question 6 deals with the allocation of expenses. With respect to surplus deductions that would otherwise result in a tax loss, the FSC is of the opinion with respect to a single class unit trust that the tax loss should then be applied against other income classes of the trust in accordance with the principle of expense allocation set out under Q6.

10. In addition to those areas of the tax law highlighted in Chapter 4, are there any other areas that may need to be updated if changes are made to the current operation of Division 6?

    The FSC considers that there are no additional areas that need to be updated.

11. Are there issues with the operation of the provisions highlighted in Chapter 4 that may need to be addressed, in addition to any changes that may need to be made to ensure that these provisions are able to operate effectively with an updated version of Division 6?

    Refer question 10 above.

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?

    The models proposed in the paper are not a marked improvement on the current design of Division 6. Those rules:

    - Allocate the entire tax liability to tax on the taxable income of a trust – either to beneficiaries, the trustee or to each in part;
    - Allocate the tax liability regardless of cash flows to beneficiaries – so that the tax system does not interfere with the distribution policies of trusts;
    - Allocate the liability using an observable criterion – the share of the trust's income which each beneficiary is entitled to demand;
    - Allocate the liability using a criterion that is commercially sensible and reflects economic gain.

    An approach that is based on these familiar design features is likely to prove the most workable and least disruptive. However, there is merit in making four adjustments to the current design:

    a) it may be that the criterion for allocating the tax liability between beneficiaries could be made broader than sharing in just "the income of" the trust estate, to a share of a larger sum such as "the net income and net gains" of the trust. Changing this criterion would make no difference to those trusts where beneficiaries have uniform rights to enjoy income and capital, but may be more applicable to those trusts where entitlements differ.

    b) The allocation of tax liabilities should be governed by the terms of the trust deed. The Regime should allow fixed trusts to allocate tax liabilities in accordance with the provisions of their trust deeds.

    c) Whatever indicator is chosen for allocating the tax liability between beneficiaries, the regime should not also require cash distributions of amounts in order for amounts to be assessed to beneficiaries. At times there are trusts that for commercial reasons do not distribute amounts representing capital gains. In addition, there may be an issue of physically distributing cash or property representing tax fictions such as TOFA amounts or accelerated depreciation (timing) or FITO's and franking credits (permanent).

d) If a broader criterion for allocating tax liability between beneficiaries is to be used, the “present entitlement’ test may need to be replaced by a broader notion, such as, ‘entitled to enjoy in the current or in future years’.

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?

The FSC makes no comment on Questions 13 to 15 as these issues are not relevant to a unit trust collective investment vehicle.

14. As highlighted in Chapter 8 the adoption of a TAD model may result in increased trustee assessments. If a TAD model was adopted is there an appropriate way to reduce the potential effects of the top marginal tax rate applying to unallocated amounts?

As highlighted in our response to question 1, the FSC proposes that in this regime the allocation of tax liabilities follows the principle that the liabilities should attach to the entities that are entitled to the economic benefits from the trust. The FSC does not support the adaptation of the TAD model.

15. If a TAD model was adopted, how should the tax law define the concept of a ‘distribution’?

See question 14 above.

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?

The FSC considers that the following transitional measures should be introduced:

a) Provisions deeming any alteration to the trust deed in order to comply with the fixed trust definitions of the new regime would not be treated as a resettlement for tax purposes;
b) Measures facilitating the merger and consolidation of trusts under the new regime. These measures would include roll over relief for the transfers of units and underlying investment assets. These facilitation measures should also allow the transfer of tax and unrealised loss benefits to the transferee trust. Many unit trusts have substantial realised and unrealised losses following the Global Financial Crisis and general downturn in the investment markets. These measures would be similar to the measures granted by the Government in 2008 to facilitate the merger of superannuation funds;
c) Measures ensuring that compliance with the new tax regime will not result in the imposition of stamp duty. The FSC acknowledges that these measures would need to be enacted by the various state and territory governments, but seeks a

commitment from the Federal Government and Treasury to liaise with the states and territories to ensure the introduction of appropriate rollover measures in each state and territory;

d) Measures need to expressly deal with the position of trusts with a substituted accounting period;

e) The position of unit holders and trusts with different accounting periods has always been a moot point. The Government should use these reforms as an opportunity to provide some certainty in this regard;

f) If significant reforms result from this process, a suitable transitional period to accommodate making the necessary changes should be provided.