30 July 2012

General Manager
Business Tax Division
Department of Treasury
Langton Crescent
PARKES ACT 2600

By email: cgt_minoramendments@treasury.gov.au

Dear Sir

Proposed minor amendments to the capital gains tax law

The Law Institute of Victoria (**LIV**) has considered the Federal Government's Proposals Paper (**Proposals Paper**), dated June 2012, on the proposed minor amendment to the capital gains tax laws (**CGT**). We set out below our preliminary comments to the questions raised in this Proposals Paper.

1. Background

The Proposals Paper sets out some welcome amendments (**the Amendments**) to the capital gains tax regime which address:

- the broadening of measures that provide CGT exemptions for certain compensation payments and insurance policies;
- the introduction of a CGT exemption for certain insurance policies owned by complying superannuation entities;
- refinements to the CGT provisions as they relate to deceased estates; and
- the broadening of CGT relief for taxpayers affected by natural disasters.

We reserve our comments regarding these specific amendments until Treasury has had the opportunity to issue a consultation paper setting out the mechanics of any amending legislation.
We do, however, wish to raise an additional issue not currently considered by the Proposals Paper. These additional issues relate to the interaction between CGT event K6 and Division 149, as well the difficulties encountered with tracing of interest through discretionary trusts, both of which are discussed in further detail below.

2. Interaction between CGT event K6 and Division 149

We refer to the interaction between the rules contained in section 104-230 of the *Income Tax Assessment Act 1997* (Cth) (**ITAA97**) and Division 149 of the ITAA97. Division 149 broadly provides a pre-CGT asset is treated to have been acquired post-CGT if:

- "ultimate owners" no longer own more than 50 percent of the direct or indirect beneficial interests that in that pre-CGT asset; or
- "ultimate owners" no longer have more than 50 percent of the direct or indirect beneficial interests in any ordinary income that may be derived from that pre-CGT asset.

The Law Institute of Victoria
is a member of

Law Institute of Victoria Ltd
ABN 32 075 475 731
Ph (03) 9607 9311 Fax (03) 9602 5270
Email lawinst@liv.asn.au
470 Bourke Street Melbourne 3000 Australia
DX 350 Melbourne GPO Box 263C Melbourne 3001
Website www.liv.asn.au

Section 104-230 of the ITAA97 sets out the circumstances which give rise to CGT event K6. Broadly, that section provides that a taxpayer may make a capital gain if:

- another CGT event (including CGT event A1 and CGT event C2) happens to shares or interests in a trust acquired before 20 September 1985 (**pre-CGT interests**); and

- the market value of property or interests owned by that company or trust that were acquired after 20 September 1985 (**post-CGT**) constitute at least 75 percent of the net value of the company or trust.

An illustration of the consequences that arise on a plain reading and application of these two provisions is demonstrated in the following instance:

> A unit trust was settled before 20 September 1985. The units in a unit trust, and the business owned by the unit trust (and therefore the goodwill owned by the unit trust), are pre-CGT. A husband and wife each individually own 25 percent of the units, and a friend owns 50 percent of the units in the unit trust. The friend sells all their units to the son of the husband and wife. Division 149 treats the pre-CGT goodwill owned by the unit trust to be post-CGT. The unitholders elect to apply the Division 124-H rollover to exchange their units for shares in a company (which will acquire the assets owned by the unit trust). The unitholders sell the company to a third party purchaser. CGT event K6 occurs in respect of the husband's and wife's shares.

It is recognised by both the Commissioner of Taxation (**Commissioner**) and taxpayers generally that where Division 149 of the ITAA97 applies to treat a pre-CGT asset as post-CGT, CGT event K6 should be applied as though that asset were still pre-CGT.

In paragraphs 64 to 67 of Taxation Ruling TR 2004/18 (**TR 2004/18**) the Commissioner states the following:

'64. For CGT event K6 purposes, the item of property is taken to have been acquired at the time the ITAA 1936 or ITAA 1997 treats the CGT asset as having been acquired. Thus, for example, if a CGT asset is taken to have been acquired before 20 September 1985 under a roll-over provision within Parts 3-1 and 3-3, the item of property will also be taken to have been acquired before that date for CGT event K6 purposes.

65. <u>An exception applies where the CGT asset is treated as having been acquired post-CGT because of the operation of Division 149. In this case, the item of property continues to be treated as having been acquired pre-CGT for the purposes of CGT event K6.</u>

66. <u>Continuing to treat the item of property as acquired pre-CGT is consistent with the objective of CGT event K6. As an anti-avoidance or transitional provision, it is designed to capture the accumulation of post-CGT acquired property in a company with pre-CGT shareholders. CGT event K6 is not targeted at the accumulation of property which is only deemed post-CGT acquired because of the operation of another anti-avoidance or transitional provision in Division 149</u>.

67. <u>Extending the context of the deeming in Division 149 to the operation of CGT event K6 could lead to one deemed result from an anti-avoidance provision adversely interacting with another deemed result from another anti-avoidance provision</u>.' [emphasis underlined]

We respectfully submit that taxpayers should not be required to rely on a taxation ruling in order to take comfort that the law operates in a manner as it was likely intended to apply (especially in instances where a literal interpretation of the CGT legislation, though disadvantageous, does not produce an "absurd" outcome). Furthermore, the Commissioner may choose to alter its views in relation to the interaction of these two provisions (see for example, item 12.6 of the National Tax Liaison Group Losses and CGT Sub-Committee minutes of 9 June 2004 regarding the small business 15 year exemption – though the change in approach was beneficial for taxpayer, the Commissioner could potentially change his views expressed on TR 2004/18 to taxpayers' detriment).

We propose that the following subsection could be inserted into section 104-230 of the ITAA97 to provide certainty to taxpayers that CGT event K6 will not occur where Division 149 of the ITAA97 treats an asset as having been acquired post-CGT:

'(11) A capital gain from CGT event K6 does not occur merely because of the operation of Division 149 of this Act.'

or alternatively:

'(11) Where Division 149 applies to property or an interest owned by a company or trust, that property or interest is treated as having been acquired before 20 September 1985 for the purposes of CGT event K6.'

Given that both the Commissioner and taxpayers currently agree that CGT event K6 should not apply merely because of the application of Division 149 of the ITAA97, and that a minor amendment to the CGT provisions would provide increased certainty to taxpayers, we respectfully submit that such an amendment is highly warranted.

3. Tracing of interests through discretionary trusts

In addition to part 2 above, we note that for the purposes of Division 149 of the ITAA97, it is not possible for a beneficiary under a discretionary trust to satisfy the "continuing majority underlying interest" test set out in section 149-30(1) of the ITAA97, as beneficiaries of a discretionary trust are not presently entitled to the income or capital of the trust until the Trustee of the trust exercises their discretion to pay, set aside or otherwise deal with that income or capital in favour of a particular beneficiary.

We respectfully submit that a provision which enables beneficiaries to be treated as though they held, or could hold, an interest in the assets subject to a discretionary trust would provide certainty as to whether there has been a change in the majority underlying interests in an asset.

Such a provision could come in two alternate forms:

- If a trustee of a discretionary trust has made a family trust election, then the trustee (itself) is deemed to be the beneficial owner for the purposes of Division 149 of the ITAA97 (in this instance, there would be no need to apply a "look through" approach, which may necessitate a complex analysis). This approach would be consistent with the trust loss provisions and the franked dividend provisions.

- Alternatively, a legislative "pattern of distribution test" could apply to a four year test period to determine which beneficiaries should be treated as the owners of a particular trust asset (given that the purpose of Division 149 of the ITAA97 is to ensure that substantially the same "beneficial owners" control the unit trust or company). In this instance, when regarding the object of a distribution (for the purposes of determining whether such a test is satisfied) the focus should be on groups of beneficiaries rather than specific and individual beneficiaries.

The proposals listed above would also be consistent with the Commissioner's views as expressed in paragraphs 5 to 8 of Taxation Ruling IT 2340:

> 5. *In relation to what are generally referred to as discretionary trusts, i.e., family trusts, the trustees of which have discretionary powers as to the distribution of trust income or property to beneficiaries, in considering the question of whether majority underlying interests have been maintained in the assets of the trust it will be relevant to take into account the way in which the discretionary powers of the trustees are in fact exercised.*
>
> 6. *Where a trustee continues to administer a trust for the benefit of members of a particular family, for example, it will not bring section 160ZZS into application merely because distributions to family members who are beneficiaries are made in such amounts and to such of those beneficiaries as the trustee determines in the exercise of his discretion.*

7. *In such a case the Commissioner would, in terms of sub-section 160ZZS(1), find it reasonable to assume that for all practical purposes the majority underlying interests in the trust assets have not changed. That is consistent with the role of the section to close potential avenues for avoidance of tax in cases where there is a substantial change in underlying ownership of assets and the legislative guidance contained in Subdivision G of Division 3 of Part III of the Act. On that basis, trust assets acquired by the trustee before 20 September 1985 would remain outside the scope of the capital gains and losses provisions of the Act.*

8. *On the other hand where, by the exercise of a trustee's discretionary powers to appoint beneficiaries or by amendment of the trust deed, there is in practical effect a change of 50% or more in the underlying interests in the trust assets - such as where the members of a new family are substituted as recipients of distributions from the trust in place of persons who were formerly the object of such distributions - the section would have its intended application as described.* [emphasis underlined].

If you would like to discuss any of the matters raised in this submission please do not hesitate to contact Angela Gidley, Commercial Law Section Lawyer, on agidley@liv.asn.au or 03 9607 9382.

Yours sincerely

Geoff Bowyer
Acting President
Law Institute of Victoria