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Dear Lyn

Draft Taxation Determination 2016/D4 and 2016/D5
Application of section 855-10 and section 99B to trust capital gains

Thank you for the opportunity to provide comments in relation to draft Taxation Determination TD 2016/D4 and TD 2016/D5 (the draft TDs) which address the interaction between section 885-10 and section 99B of the Income Tax Assessment Act 1997 and 1936 respectively (the Act) to certain trusts.

The Property Council is the peak body representing the interests of owners and investors in Australia's $670 billion property investment industry. The Property Council represents members across all four quadrants of property investment, debt, equity, public and private.

Industry does not support finalising the draft TDs. The draft TDs propose that Australian investors (including a managed investment trust, MIT), that invests offshore via a foreign trust, will be taxed on any capital gains of the foreign trust as ordinary income under s99B and will not be entitled to a CGT discount in respect of those capital gains.

The proposed tax outcome is inconsistent to the position if the Australian investor invests directly in the offshore asset, or through a flow through vehicle which is not a trust – these holdings would be eligible for the CGT discount. This means Australian investors will be subject to a higher tax liability where a MIT invests in offshore property via a foreign trust.

Industry strongly recommends that the ATO further considers the adverse impact of the draft TDs on the managed funds industry. The TDs must achieve an outcome that ensures tax neutrality between direct investments and investments through a collective investment vehicle and one that does not favour one form of foreign investment over another.

In the event the ATO maintains the view that this interpretation is not available, industry recommends that the ATO work with industry and Treasury to ensure Australian investors investing via a MIT should receive the same CGT outcome whether the MIT invests directly in foreign assets or indirectly in foreign assets via a foreign trust.

Overall effect of the ATO's proposed interpretation

The ATO's proposed interpretation of section 855-10 and section 99B will impact Australia's ability to operate as a global funds management centre.

The ATO's interpretation of section 855-10 and section 99B, as set out in the draft TDs, will result in higher tax liabilities for Australian investors of a MIT, where that MIT invests in offshore assets via a foreign trust.

The draft TDs give rise to different tax outcomes depending on the manner in which a foreign asset is held. That is, an Australian investor (including a MIT) has a different Australian tax outcome if it invests directly in a foreign asset or through a flow through entity which is not a trust when compared to the Australian tax outcome for an indirect investment through a foreign trust.

In summary, the draft TDs do not achieve the correct outcome where an Australian fund manager operates a fund that invests in offshore assets through a foreign trust as:

- Australian investors will not be eligible for the CGT discount and will be subject to higher rates of tax on foreign capital gains; and

- Australian investors will obtain no recognition for foreign capital losses made by the foreign trust.

The outcome for a foreign trust that holds both Australian and foreign assets is particularly problematic. It would seem that any capital loss on a foreign asset could not be offset against any capital gain on an Australian asset.

The ATO's proposed position will also effect the commercial decisions made by wholly Australian funds. An Australian fund could make a direct investment in foreign assets and obtain full recognition for capital gains and losses. However, if it invests through a trust in the foreign jurisdiction, investors will be taxed on foreign capital gains without the benefit of the CGT discount or the ability to offset capital losses. Thus, if the Australian fund wishes to use a foreign fund manager, it will need to make bespoke arrangements to invest alongside any trust operated by the foreign fund manager.

Australian funds holding foreign assets through sub-trusts will also be disadvantaged as they will be compelled to use Australian trusts to invest in those assets, even where a local vehicle would be preferred for commercial or foreign tax reasons. Where an investor is forced to use a local vehicle, the ATO's position will have the same effects as described above for funds.

The ATO's proposed interpretation is also inconsistent with broader policy objectives relating to:

- collective investment vehicles, including MITs – for example, the OECD commentary on the model tax convention discusses the importance of neutrality between direct investments and investments through a collective investment vehicle; and
- promoting Australia as a global funds management hub – for example, the 2009 Johnson Report highlighted the potential economic benefits of growing Australia's funds management industry, both in terms of increasing offshore investors investing in Australian funds and Australian funds increasingly managing offshore assets

Alternative interpretations

We set out below detailed analysis on the more appropriate interpretation of section 885-10 and section 99B, having regard to the policy intent of the Act and the broader policy objectives underpinning collective investment regimes.

Interpretation of section 855-10(1)

The draft TDs set out the ATO's view that section 855-10 operates to disregard a capital gain (or capital loss) in relation to a non-TAP asset made by a trustee of a "foreign trust for CGT purposes" for all purposes of the Act.

It is not clear that this is the correct position. We submit that section 855-10 operates to disregard such a capital gain or loss in determining the tax liability of the trustee and not the beneficiaries of the trust. That is, the calculation of the net income of the trust estate depends upon the purpose for which that calculation is being performed:

- if it is being performed for the purpose of determining the liability of the trustee, the capital gain is disregarded; and

- it is being performed for the purpose of determining the liability of a beneficiary, the capital gain is not disregarded.

If a particular beneficiary is a non-resident, the non-resident may be entitled to disregard the trust capital gain attributed to it under section 855-40 (for a fixed trust) or on the basis that the capital gain not have an Australian source (for other trusts).

Factors pointing in favour of this alternative outcome are:

- section 855-10(1)(a) states "*Disregard a *capital gain or *capital loss from a CGT event if: (a) you are … a trustee of a *foreign trust for CGT purposes …*". By contrast, the position of a beneficiary is determined by reference to the net income of the trust estate. Section 855-10 does not refer to the trust estate.

- it provides an outcome that accords with the overall policy of the Act. In particular:
  - the intention of section 855-10 and its predecessors is to ensure that Australia does not claim universal jurisdiction over capital gains by excluding non-residents from taxation in respect of "foreign" assets. Because a trustee of a trust is not a resident (in that capacity) these entities must be excluded separately;
  - there is no intention for the residence of the trust to affect the taxation of an Australian resident beneficiary (taxed on a current year present entitlement basis). Foreign income, for example, flows to an Australian resident beneficiary unaffected by the residence of the trust;
  - Division 6AAA of Part III protects the revenue where income is retained in a foreign trust with Australian beneficiaries;
  - foreign beneficiaries of foreign trusts are protected from taxation in respect of foreign assets through separate exemptions – section 855-40 for fixed trusts and the general rules on source for other trusts.

Limiting section 855-10 to the taxation of the trustee in its personal capacity ensures that section 98, section 99 and section 99A do not apply to the trustee of a foreign trust in respect of foreign assets while ensuring that both resident and non-resident beneficiaries are substantially in the same position as they would have been if they had held the asset directly.

The alternative position set out in the draft TDs inevitably results in under-taxation or over-taxation if the position is that section 99B applies when the foreign trust distributes the capital gain. For example:

- if the CGT discount is available to the hypothetical taxpayer in section 99B, then under-taxation may arise in some circumstances because all Australian beneficiaries of a foreign trust would effectively be entitled to the CGT discount. If the foreign trust is a discretionary trust, there would be no claw-back of the untaxed part under CGT event E4; and

- if the CGT discount is not available to the hypothetical taxpayer in section 99B, then over-taxation will arise in some circumstances because no Australian beneficiaries of a foreign trust would be entitled to the CGT discount (or entitled to apply capital losses).

The Commissioner has suggested that the proposed interpretation has the effect that a non-resident beneficiary could be subject to tax on foreign capital gains made by a foreign trust. We do not consider that is correct, as:

- a foreign beneficiary of a fixed trust will be protected by section 855-40; and

- a foreign beneficiary of a non-fixed trust will be protected by the general rule that the tax rules do not tax foreign income of non-residents. It would be expected that a capital gain realised on the disposal of a foreign asset by a foreign trust would have a foreign source.

The Commissioner has also suggested that:

> " …[the proposed] *approach would also require the trustees of foreign trusts to maintain records for their worldwide assets so as to determine capital gains and losses from those assets for Australian tax purposes. This is an unnecessary administrative burden.*"

Many foreign trusts distributing foreign capital gains to Australian residents will be controlled by those Australian residents and those entities will have full access to the records of the trust.

In any event, the tax law already assumes that every Australian resident beneficiary of every foreign trust will be able to precisely calculate the net income of the trust for the purposes of applying Division 6 and Division 6AAA of Part III of the *Income Tax Assessment Act 1936*. It does this despite there being no obligation on foreign trustees to any maintain Australian tax records. In light if this, we consider that the appeal to 'administrative burden' is misplaced.

Interpretation of section 99B

On its face, section 99B applies to include any distribution by a trust in the relevant beneficiary's assessable income, unless the amount is otherwise subject to tax. However, there is an exclusion for:

- an amount representing corpus of the trust estate, except to the extent to which it is attributable to amounts derived by the trust estate that, if they had been derived by 'a taxpayer being a resident', would have been included in the assessable income of that taxpayer for a year of income; and

- an amount that, if it had been derived by a taxpayer being a resident, would not have been included in the assessable income of that taxpayer of a year of income.

In private ruling 1012694430183 the Commissioner described this test as follows:

> *To determine if the amounts received by you are assessable income under subsection 99B(1) of the ITAA 1936, we need to consider the hypothetical test in paragraph 99B(2)(a) of the ITAA 1936.*
>
> *The hypothetical test is whether amounts received by the trust in relation to the sale of the land would have been assessable to the trust* ***if the trust was a resident of Australia****.* [emphasis added]

Under this interpretation, only 50% of capital gains on assets held for more than 12 months would be subject to section 99B. Although an Australian resident individual or trust beneficiary would be denied capital account treatment under TD 2016/D4, at least it would not be assessed on an excessive amount of income.

However, in TD 2016/D5, the Commissioner now states:

> "*Paragraph 99B(2)(a) of the ITAA 1936 refers to an amount derived by 'the trust estate', but then hypothesises a scenario in which that amount was derived by 'a taxpayer being a resident'. It is evident from this language that the hypothetical taxpayer is not the trustee of the trust, but an entirely separate, fictional entity.*"

In support, the Commissioner notes:

> "*If the position were otherwise, section 99B of the ITAA 1936 would effectively enable corporate beneficiaries to benefit from the CGT discount, contrary to the intention of Subdivision 115-A of the ITAA 1997. Under such an approach, a resident company would obtain a greater benefit investing through a foreign trust, or a chain of trusts including a foreign trust, than if it had invested in the underlying asset directly.*"

Clearly, the ATO's position amounts to a "U turn" as contemplated in PSLA 2011/27.

The effect of the ATO's new position is that an Australian resident beneficiary of a foreign trust is not only denied capital account treatment in respect of gains on foreign assets but it is to be assessed on 100% of those gains. This is the case even if the resident is an individual or complying superannuation fund. The Commissioner does not state how this outcome accords with the intention of Subdivision 115-A.

Recommendation

Industry strongly recommends that the ATO further considers the adverse impact of the draft TDs on the managed funds industry. The TDs must achieve an outcome that ensures tax neutrality between direct investments and investments through a collective investment vehicle and one that does not favour one form of foreign investment over another.

In the event the ATO maintains the view that this interpretation is not available, industry recommends that the ATO work with industry and Treasury to ensure Australian investors investing via a MIT should receive the same CGT outcome whether the MIT invests directly in foreign assets or indirectly in foreign assets via a foreign trust.

In the meantime, we recommend the ATO release a statement along the lines of:

The ATO will not direct compliance resources towards taxpayers where:

- *beneficiaries are presently entitled to all of the income of a foreign trust estate at the end of each year and an Australian resident or resident trust estate has included its share of the net income of the foreign trust in its assessable income; and*

- *the Australian resident or resident trust estate has calculated its share of the net capital gain of the foreign trust taking into account capital gains and capital losses from CGT events that happen in relation to all the CGT assets of the foreign trust.*

At a minimum, the ATO should apply the views in TD 2016/D4 and TD 2016/D5 on a prospective basis only.

We are keen to meet and talk through our industry recommendations at your earliest convenience.

Please let us know when you would be available and in the meantime, if you have any queries, please do not hesitate to contact me on 02 9033 1929.

We look forward to discussing this further with you.

Yours sincerely
Belinda Ngo
Director of Tax Policy
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