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AUSTRALIA + NEW ZEALAND

4 October 2019

Ms Karen Rooke
Australian Taxation Office

By email: Karen.Rooke@ato.gov.au

Dear Karen,

TD 2019/D6 and TD 2019/D7

Chartered Accountants Australia New Zealand (CA ANZ) appreciates the opportunity to provide feedback on the draft tax determinations:

- TD 2019/D6 Income tax: does Subdivision 855-A (or subsection 768-915(1)) of the *Income Tax Assessment Act 1997* disregard a capital gain that a foreign resident (or temporary resident) beneficiary of a resident non-fixed trust makes because of subsection 115-215(3)? (TD 2019/D6); and
- TD 2019/D7 Income tax: is the source concept in Division 6 of Part III of the *Income Tax Assessment Act 1936* relevant in determining whether a non-resident beneficiary of a resident trust (or trustee for them) is assessed on an amount of trust capital gain arising under Subdivision 115-C of the *Income Tax Assessment Act 1997*? (TD 2019/D7).

Together, these are referred to in this submission as the Draft Determinations.

Overall comments

CA ANZ does not support the Commissioner's preliminary views outlined in the Draft Determinations.

The outcomes of the Australian Taxation Office (ATO)'s interpretation of existing law under the Draft Determinations are not aligned with the overarching policy of the trust tax provisions which seek to place the beneficiary in the same position as a direct investor and are inconsistent with basic international taxation principles.

A position where Australia seeks to tax a foreign resident on foreign sourced capital gains that are not Taxable Australian Property (TAP) is, in our opinion, unsustainable.

We believe these issues should be escalated with Treasury for consideration from a policy design perspective.

Our detailed comments on the Draft Determinations are set out in the attached.

Submission on TD 2019/D6 and TD 2019/D7

To discuss this submission further, please contact Karen Liew at first instance on (02) 8078 5483 or by email on karen.liew@charteredaccountantsanz.com.

Yours sincerely,

Michael Croker
Tax Leader Australia
Chartered Accountants Australia and New Zealand

Detailed Comments

1. TD 2019/D6

The Commissioner's preliminary view in TD 2019/D6 is that section 855-40 of the *Income Tax Assessment Act 1997* (ITAA 1997) only disregards a capital gain that a foreign resident beneficiary makes in respect of a CGT asset that is not TAP because of sub-section 115-215(3) if the trust is a *fixed* trust. Section 855-10 (or sub-section 768-915(1)) does not disregard a capital gain that a foreign resident (or temporary resident) beneficiary of a resident trust makes in relation to a non-TAP CGT asset because of sub-section 115-215(3).

Section 855-10(1) essentially allows a capital gain (or a capital loss) to be disregarded from a CGT event that happens to a CGT asset that is not TAP if you are a foreign resident or the trustee of a foreign trust for CGT purposes just before the CGT event happens.

We do not support:

- the policy justifications for limiting relief to capital gains where beneficiaries have interests in fixed trusts, and
- the ATO's reliance of the enactment section 855-40 expressly dealing with fixed trusts.

to disallow a foreign resident beneficiary of a resident non-fixed trust to apply section 855-10 to disregard a capital gain relating to non-TAP assets.

Overarching policy intent underlying the tax treatment of capital gains under a trust

The objective of introducing Division 855 was "to better target and strengthen Australia's CGT laws by more closely aligning Australia's laws with OECD practice through narrowing the range of assets on which foreign residents will be subject to Australian CGT."[1] However, the policy underlying the tax treatment of trust income has been more complex and the subject of multiple changes over the years.

As succinctly set out in the *Greenwoods Riposte* "International Tax Trust Morass – Again!" (list 1 to 7), there have been multiple changes to the tax law treatment of trust level capital gains for beneficiaries over a 33 year period. Each change was for a specific purpose and the explanatory memorandums for each change focused on that specific purpose. However, the underlying policy intent has consistently been stated as the conduit treatment of trust income. Applying the policy of conduit treatment of trust income, foreign beneficiaries should not be taxable on capital gains derived by a resident trust that are not both Australian sourced and TAP.

[1] Paragraph 4.128 of Explanatory Memorandum to Tax Laws Amendment (2006 Measures No. 4) Bill 2006

Interpreting the relevant statutory provisions in light of old policy

The ATO has argued that the general exemption in section 855-10 should not apply to a foreign resident beneficiary as the capital gain from a CGT event does not happen to the beneficiary, rather the CGT event happens to the trustee.

Although the ATO acknowledges that **subsection 855-10(1) does not expressly provide that the relevant CGT event must happen to the foreign resident**, the ATO has inferred from statutory context that the relevant CGT event must happen to the beneficiary (paragraph 19 of the TD 2019/D6). In view of the changes to the tax law treatment of capital gains and trusts over time, we submit that the ATO should reconsider applying this inference based on policy views back in 2004.

Furthermore, we urge the ATO to reconsider its concern with rendering the fixed trust aspect of section 855-40 redundant if section 855-10(1) could be interpreted as disregarding trust capital gains attributed to foreign resident beneficiaries on its own terms without regard to whether a trust was a fixed or non-fixed trust (paragraph 21 of TD 2019/D6). This would not be the first time that provisions of the tax law have been made effectively redundant as a result of an ATO view. For example, when the ATO released *TR 2010/3 – Income tax: Division 7A loans: trust entitlements*, treating an unpaid present entitlement of a corporate beneficiary as financial accommodation and therefore potentially subject to deemed dividend treatment under Division 7A, the provisions under Subdivision EA of the ITAA 1936 effectively became redundant.

The 2004 policy purpose underlying capital gains made by foreign residents through fixed trusts

We note Division 855 was enacted in 2006. According to paragraph 4.114 of the explanatory memorandum to Tax Laws Amendment (2006 Measures No. 4) Act 2006 (the legislation introducing Division 855), the amendments moved a specific treatment for capital gains and capital losses made by foreign residents from interests in, or through interests in, fixed trusts from Subdivision 768-H into Division 855.

In 2004, Subdivision 768-H was specifically introduced to address the situation where non-residents investing in Australian assets through an Australian managed fund were taxed more heavily than if they invested directly in those assets or through a non-resident fund. This sub-division was aimed at improving the international competitiveness of Australian managed funds, increasing their attractiveness to foreign investors investing in Australian and the region – a specific purpose. However, a trust had to meet the definition of 'fixed trust' to apply 768-H**.** This was to ensure that there was no discretion available to the trustee to provide benefits to parties who were not beneficiaries of the trust. That is, the requirement to be a 'fixed trust' served an integrity purpose.

Trust tax policy has evolved since the Bamford High Court decision

The tax law concerning trusts has evolved since the introduction Sub-division 768-H. This is mainly due to the 2010 High Court decision in *Commissioner of Taxation v Bamford* (2010) 240 CLR 481. In that case, the High Court considered the meaning of 'income of the trust estate' and the meaning of 'share' for the purposes of section 97 of the *Income Tax Assessment Act 1936* (ITAA 1936).

With regard to the meaning of 'share' the Court found that 'share' meant 'proportion' such that once the share of the distributable income of the trust to which the beneficiary is presently entitled is determined, the beneficiary is assessed on that same percentage share of the trust's net income as defined in section 95 of

the ITAA 1936. Because of this proportionate approach, it was not clear how this interacted with capital gains and franked distributions and whether they could be treated as having the same character in the hands of a beneficiary as they had in the hands of a trustee and thus be streamed under the tax law

Accordingly, amendments to subsection 115-215(3) were introduced in 2011. The primary purpose of the amendments to Subdivision 115-C in 2011 was to ensure that, where permitted by a trust deed the 'streaming' of capital gains and franked distributions to beneficiaries was effective for tax purposes (paragraph 2.25 of the explanatory memorandum to Tax Laws Amendment (2011 Measures No.5) Act 2011). That is, the government of the day made the decision to enable capital gains and franked distributions to have the same character in the hands of a beneficiary of a non-fixed trust as they had in the hands of a trustee so that they could effectively be streamed under the tax law. Provisions were also introduced to deal with the main integrity concern with allowing streaming.

Therefore, if subsection 855-10(1) and subsection 115-215(3) were interpreted in view of the overarching trust tax policy of conduit treatment of trust income and international practice of taxing foreign residents only on TAP, then a foreign resident beneficiary should be able to disregard a capital gain from a CGT event if the event happened in relation to a non-TAP CGT asset held by a resident trust.

Moreover, there is still nothing in the tax legislation that expressly states that a foreign beneficiary of a non-fixed trust cannot apply section 855-10(1) when working out its net capital gain under subsection 115-215(3) and Division 102.

We therefore urge the ATO to reconsider its views in the TD 2019/D6.

2. TD 2019/D7

CA ANZ is not convinced that the source concept in Division 6 of Part III of the ITAA 1936 is not at all relevant in determining whether an amount of trust capital gain is assessable to the non-resident beneficiary or trustee.

We note that paragraph 14 of the TD 2019/D7 states that section 115-220 does not test whether the beneficiary's attributable gain satisfies the conditions in section 98 of the ITAA 1936. Rather it increases the amount assessable to the trustee under section 98 without regard to those conditions. We agree with this observation.

However, TD 2019/D7 lacks any discussion around the application of paragraph 115-220(1)(b) which is part of the test to determine when section 115-220 will actually apply. Assuming a beneficiary was presently entitled to a share of income of the trust, section 115-20 would apply if you (i.e. trustee) would be liable to be assessed (and pay tax) under section 98 of the ITAA 1936. The reference to section 98 of the ITAA 1936 brings in the source concept (i.e. in a subsection 98(3) or 98(4) situation – where the beneficiary is a non-resident at the end of the year of income – the trustee is only assessed and liable to pay tax on that proportionate share of the trust's net income that is attributable to sources in Australia).

Appendix 1 should include discussion as to what is actually required to satisfy section 115-220(1)(b) and the reference to section 98. Even if the ATO is of the view that the source concepts in section 98 are not applicable, it should discuss this in an alternate view section. We note that TD 2019/D6 has an alternate views section but TD 2019/D7 does not.

In the event that the view expressed in TD 2019/D7 is not changed, CA ANZ supports the ATO's compliance approach in relation to the date of effect of TD 2019/D7 where in relation to the 2018-19 and earlier income years the Commissioner will not seek to disturb approaches taken for capital gains from non-TAP assets of the trust which are consistent with the source principles present in the pre-2011 streaming legislation, given the complexity.

Tax treaty interactions

Both Draft Determinations state that they do not consider the application of Australia's double taxation agreements.

Given the significance of the consequences of the views expressed in the Draft Determinations - that is, Australia may impose tax on foreign sourced, non-TAP capital gains derived by a foreign resident - we consider it remiss that the ATO has not considered the application of Australia's double tax agreements nor provided any guidance on this issue to affected taxpayers either within these Determinations or elsewhere.

The application of double tax treaties to gains derived via a discretionary trust, and in scenarios potentially involving multiple countries, is a complex area of international tax law that warrants urgent consideration by the ATO.

Appendix A

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