JOINT SUBMISSION BY

The Tax Institute, Chartered Accountants Australia and New Zealand, Tax and Super Australia, CPA Australia and Institute of Public Accountants

Draft Taxation Determination TD 2016/D4

Income tax: does the residency assumption in subsection 95(1) of the Income Tax Assessment Act 1936 (ITAA 1936) apply for the purpose of section 855-10 of the Income Tax Assessment Act 1997 (ITAA 1997), which disregards certain capital gains of a trust which is a foreign trust for CGT purposes?

AND

Draft Taxation Determination TD 2016/D5
Income tax: where an amount included in a beneficiary's assessable income under section 99B(1) of the Income Tax Assessment Act 1936 (ITAA 1936) had its origins in a capital gain from non-taxable Australian property of a foreign trusts, can the beneficiary offset capital losses or a carry-forward net capital loss ('capital loss offset) or access the CGT discount in relation to the amount?

Date: 10 March 2017

The Professional Bodies welcome the opportunity to comment on Draft Taxation Determination TD 2016/D4 and Draft Taxation Determination TD 2016/D5 ("the Draft Determinations").

GENERAL COMMENTS

Any interpretation of the tax laws should be consistent with the express purpose or objects of those laws. In this regard, it is useful to note that the purpose of s 115-215 of the *Income Tax Assessment Act 1997* (Cth) (**ITAA 1997**) is set out in s 115-215(1) in the following terms:

> **SECTION 115-215 Assessing presently entitled beneficiaries**
> **Purpose**
> 115-215(1) The purpose of this section is to ensure that appropriate amounts of the trust estate's net income attributable to the trust estate's *capital gains are treated as a beneficiary's capital gains when assessing the beneficiary, so:
> (a) the beneficiary can apply *capital losses against gains; and
> (b) the beneficiary can apply the appropriate *discount percentage (if any) to gains.

The object of Subdivision 855-A – entitled "Disregarding a capital gain or loss by foreign residents" – is similarly set out in s 855-5 in the following terms:

> **Subdivision 855-A - Disregarding a capital gain or loss by foreign residents**
> **SECTION 855-5 Objects of this Subdivision**
> 855-5(1) The objects of this Subdivision are to improve:
> (a) Australia's status as an attractive place for business and investment; and
> (b) the integrity of Australia's capital gains tax base.

It can therefore be seen that both s 115-215 (the purpose of which is to assess presently entitled beneficiaries) and Subdivision 855-A (the purpose of which is to disregard capital gains or losses of non-residents as evident from its title and express objects) focus on the assessment or non-assessment as the case may be of beneficiaries of trusts.

Section 115-215 especially is intended to assess beneficiaries in an “appropriate” way, including applying the CGT discount if it is relevant.

Furthermore, in our opinion, the policy underlying the interpretation of the matters covered by the two Draft Determinations should be that a taxpayer gets the same tax outcomes whether or not capital gains are received by an Australian resident via an Australian trust or a foreign trust.

We also believe the Draft Determinations do not properly apply s 99B and the reasoning for including the full amount in the beneficiary’s assessable income is critical. We believe the Draft Determinations should be withdrawn and the application of s 99B be properly addressed in the revised Draft Determinations.

Character retention

The conduit approach (pursuant to which income retains its character through a trust) was articulated by the High Court in *Charles v Federal Commissioner of Taxation* (1954) 90 CLR 598.

The conduit approach, which underpins the taxation of trusts, has the effect that:

- a capital gain derived by a foreign trust retains its character on distribution to an Australian resident investor; and
- an Australian resident investor (individual, complying superannuation fund, trust) is entitled to the CGT discount and is entitled to offset capital losses against such capital gains.

The Commissioner’s view in Draft Determinations D4 and D5 that a capital gain does not retain its character through a trust – especially in relation to gains which are distributed by a trust in the same year as that in which they are made – cannot be sustained, given that it contravenes the fundamental principle that income retains its character through a trust.

SPECIFIC COMMENTS

TD 2016/D4

In our opinion, the tax outcome described in Draft Determination D4 is not consistent with the stated intention[1] of the provisions of the tax law relating to the assessment of capital gains in the hands of trust beneficiaries. This is especially the case where the gain made by a foreign trust is distributed to an Australian beneficiary (ie, that beneficiary is made presently entitled to it) in the same financial year as that in which it is made.

There is no tax mischief in that context and we question why, as a matter of policy, an Australian beneficiary should be taxed differently if the capital gain in question had instead been made by an Australian trust and distributed to the same Australian beneficiary in the same financial year, or the next, as was described in the example involving The Kiwi Trust.

Remembering the object of Subdivision 855-A mentioned above, we submit that interpreting s 855-10 as described in Draft Determination D4 is contrary to the object of “improving … Australia’s status as an attractive place for business and investment[2]” when a simpler, purposive approach such as that described below could achieve a consistent and, we submit, more appropriate outcome.

---

[1] Refer to the ‘Guide’ box at Subdivision 115-C of ITAA 1997

[2] Section 855-5(1)(a)

Perspective

In our opinion, a result matching the purpose described in s 115-215(1) could be achieved if one considered that:

- the s 95[3] residency assumption was applied to calculate the trust's net income;
- the machinery provisions (eg, of s 97) then applied to determine in whose hands that net income was assessable; and
- only then would s 855-10 be applied ***from the perspective of the beneficiary***.

We note that s 855-10 does make specific reference to disregarding a capital gain of "a trustee of a foreign trust for CGT purposes". However, as an operative provision, this should only apply in situations where the trustee would prima facie be assessed on that capital gain (e.g. where no beneficiary is presently entitled to it).

This important matter of applying s 855-10 and s 95 from the perspective of the beneficiary is consistent not only with:

- how the title of Subdivision 855-A directs and informs the reader (referring as it does to gains made "by foreign residents" and not just to gains made by trusts that are foreign trusts for CGT purposes); and
- how the machinery provisions of Division 6 and Subdivision 115-C operate together to apply any CGT discount at the beneficiary level; but also
- the general principle that trust income should retain its character as it flows through a trust.

Broader application

A parallel can be seen between the Controlled Foreign Company (**CFC**) residency assumption in s 383 of the ITAA 1936 and that in s 95. The residency assumption uses similar language for the purposes of calculating the attributable income of a CFC – "the eligible CFC is a taxpayer and resident" – which is comparable to the wording used in s 95 for the purposes of determining net income: "as if the trustee were a taxpayer and a resident". If s 383 were interpreted in the way proposed in Draft Determination D4 for s 95 and s 855-10, a CFC could never derive attributable income in relation to gains from non-TAP assets. This is clearly not the intended outcome nor an appropriate one.

No conflict

In our opinion, there is no conflict between s 95 and s 855-10. Both provisions are specific to their own purposes and context: s 95 to the calculation of a trust's net income for the purpose of assessing presently entitled beneficiaries and s 855-10 to "disregarding a capital gain or loss by foreign residents".

Section 855-10 should operate to disregard capital gains or losses made by a **trustee** and not beneficiaries. Section 855-10 reads:

> **SECTION 855-10 Disregarding a capital gain or loss from CGT events**
> **855-10(1)**
> Disregard a *capital gain or *capital loss from a *CGT event if:
> (a) you are a foreign resident, or the **trustee** of a *foreign trust for CGT purposes, just before the CGT event happens; and
> (b) the CGT event happens in relation to a *CGT asset that is not *taxable Australian property. (Emphasis added)

A resident beneficiary is taxed by reference to the s 95 net income of a trust estate. The two provisions have quite different functions, so there is no inconsistency between s 855-10 and

[3] *Income Tax Assessment Act 1936* (Cth) (**ITAA 1936**)

s 95. It follows that the argument in paragraph 11 of Draft Determination D4 that s 855-10 ‘would have no operation at all in relation to foreign trusts’ cannot be sustained.

This approach also makes sense as it should mean that resident and non-resident beneficiaries would be in the same position as if they had owned the asset directly.

Even if there were a conflict between the two provisions (which there isn’t), we consider that it is not a matter of working out which provision overrides the other; instead, the purposive approach described above achieves appropriate outcomes. As mentioned above, it cannot be said that one is a general provision and the other is specific; accordingly, one does not necessarily override the other without due consideration of legislative purpose.

The inappropriateness of the tax outcome from the position put forward in Draft Determination D4 is illustrated further in the example below.

> *Example: Industry Super*
>
> Industry Super, a public-offer superannuation fund, offers its members an investment choice of foreign property. Those foreign property investments are placed through foreign-resident unit trusts which receive rental income each year and make capital gains when properties are sold.
>
> The foreign-resident unit trusts distribute their net rental income and capital gains each year and do not accumulate any income or gains.
>
> Using the words of s 115-215(1), an “appropriate” way to assess the net rental income and capital gains is for Industry Super to be assessable on those amounts in the year they are derived/made by the foreign-resident unit trusts at the tax rates applicable had those unit trusts instead been resident in Australia. Otherwise, there would be created an inappropriate and unwarranted bias towards investing in an Australian entity when that can be difficult to do in some countries.
>
> That bias might also render certain investments effectively “off limits” to Australian superannuation funds, hindering their ability to pool their investments with non-Australians and thereby benefit from economies of scale.

TD 2016/D5

The conclusion drawn in Draft Determination D5 that the amount is included in assessable income under s 99B(1) would seem to be incorrect. There is no provision of the tax law that requires the hypothetical resident taxpayer to include the amount (being the capital gain derived by the trustee) in assessable income on the assumption that the hypothetical taxpayer had derived it. The hypothesis posited by both s 99B(2)(a) and s 99B(2)(b) is similar and preserves or retains the character of ‘the amount’ under consideration – thus, the capital gain derived by the trustee is assumed to have been derived by the hypothetical resident taxpayer (see *Howard v FCT* [2012] FCASFC 149 at [48]). Being capital, it is not included in assessable income by sec 6-5. Whilst details about the amount are known, as noted in both the *Union Fidelity* case[4] and *Howard*, no other fact is known about the taxpayer other than residence. Thus, it cannot be concluded that the TOFA provisions would make the capital gain assessable income. Part 3-1 does not include a capital gain in assessable income. Rather, s 102-5 includes the taxpayer’s ‘net capital gain’ in assessable income and this is calculated in accordance with the method statement in s 102-5(1). To calculate a net capital gain, the following details need to be known: (i) details of the taxpayer’s capital losses of the year and the choice of applying them to reduce capital gains made in the year (step 1, note 1); (ii) details of disregarded gains (step 1, note 2); (iii) unapplied net capital losses of prior years (step 2); (iv) discount capital gains (step 3); and (v) capital gains qualifying for small business tax concessions (step 4). As was the case in *Union Fidelity* (per Barwick CJ

[4] Union Fidelity Trustee Co of Australia Ltd v Federal Commissioner of Taxation 69 ATC 4084

at 4086), if nothing is known as to these matters, it cannot be the case that the amount will be included in the hypothetical taxpayer's assessable income.

The Commissioner's preferred interpretation of s 99B as put forward in Draft Determination D5 produces the absurd result that a capital gain distributed by a foreign trust to a resident individual would not benefit from the CGT discount when, had the same non-TAP asset been sold by a resident trust and the resulting capital gain distributed to the same resident individual, the contrary would have happened.

The Commissioner cites the *Union Fidelity* case as authority for his view that the hypothetical taxpayer posited by s 99B(2)(a) and (b) is a non-specific taxpayer in a non-specific year of income.

This reliance is misplaced.

In fact, the quoted passage from *Union Fidelity* at paragraph 17 of Draft Determination D5 deals with the s 95 definition of *net income of a trust estate* which was quoted by Barwick CJ as follows:

> The definition of "the net income of a trust estate" is to be found in s. 95 and is as follows-
> " 'The net income of a trust estate' means the total assessable income of the trust estate calculated under this Act as if the trustee were a taxpayer in respect of that income, less all allowable deductions, except the concessional deductions and except also, in respect of any beneficiary who has no beneficial interest in the corpus of the trust estate, or in respect of any life tenant, the deduction of such of the losses of previous years as are required to be met out of corpus."
> ………
>
> The effect of the definition of the net income of the trust estate in s. 95 is that the provisions of the Act are to be applied to the actual income of the trust estate ***as if it were the income of an individual deriving it***. From the actual income of the trust estate there are abstracted all sums which can be seen to be assessable income. For the purpose of this abstraction or computation the only fact which is relevantly known is that the trustee, as a taxpayer, has derived the income. The residence of the trustees, or of any one of them, if there be more than one cannot afford a reason for varying the net amount of the income of the trust estate according to the accident of the trustee's residence in the year of tax. Its irrelevance is emphasized when the possibility of diverse residences of several trustees is contemplated. (Emphasis added)

When seen in context, the last passage quoted by the Commissioner can be seen to relate to the wording of s 95 that appeared shortly before.

It can also be seen that s 95 at the time only referred to "the total assessable income of the trust estate calculated under this Act as if the trustee were a taxpayer in respect of that income". No mention of an "individual" appears in that definition. Despite this, the High Court said at paragraph 6 of the *Union Fidelity* judgement that "the provisions of the Act are to be applied to the actual income of the trust estate as if it were the income of an individual deriving it."

The *Union Fidelity* case therefore – instead of supporting the Commissioner's position – actually contradicts it and requires the enquiry under s 99B(2)(a) and (b) to be made on the basis that the hypothetical taxpayer were an individual.

Ambit of section 99B

The statutory context and legislative purpose of section 99B was summarised by Hill J, in *Traknew Holdings Pty Ltd v FCT* 91 ATC 4272, as follows:

59. The application of s.99B also presents difficulty. Literally, the section is capable of applying in the circumstances of the present case. However, the section was not enacted to render assessable payments or applications to the benefit of discretionary beneficiaries. Such payments or applications were already made assessable income by force of s.97 alone or in combination with s.101, leaving aside a case where s.98 applies but the presently entitled beneficiary is under a legal disability where the trustee is assessable.

60. **The provisions of s.99B can only be understood in their historical context.** The need for some such provision was discussed by the Taxation Review Committee (the Asprey Committee) in its report of 31 January 1975. The problem exposed by cases such as *Union Fidelity* was that ss.99 and 99A had no application where accumulated income was derived from a source outside Australia. If the trust income was accumulated and became capital, its subsequent receipt by a beneficiary was neither assessable income under ss.25 or 26(b). Section 99B together with ss.99C and 99D were introduced into the Act by the Income Tax Assessment Amendment Act No.5 of 1978. As the Explanatory Memorandum circulated with that Act discloses to deal:

> "... primarily with the receipt by resident beneficiaries of distributions from non resident trust estates of previously untaxed foreign sourced income."

61. The Explanatory Memorandum makes the following relevant comments on s.99B:

> "The proposed section 99B will require the inclusion in a beneficiary's assessable income of amounts paid to or applied during a year of income for the benefit of a resident beneficiary where that amount represents trust income of a class which is taxable in Australia but which has not previously been subject to Australian tax in the hands of either the beneficiary or the trustee. It will normally apply where accumulated foreign sourced income of a non resident (or of a resident trust estate that previously was not able to be taxed in Australia in the light of the Union Fidelity decision) is distributed to a resident beneficiary."

62. **It is not necessary to decide for the purposes of the present case whether the extreme width of s.99 B and associated sections require it to be read down having regard to the obvious legislative purpose in enacting it**. (Emphasis added)

Hill J noted the "*extreme width*" of s 99B, and "*having regard to the obvious legislation purpose in exacting it*".

Coupled with the principles of statutory construction, most recently outlined by the High Court in *Commissioner of Taxation v Unit Trend Services Pty Ltd* (2013) 250 CLR 523, it is submitted that the Commissioner's view in Draft Determination D4 and Draft Determination D5 cannot be sustained.

In particular, the Commissioner's view in Draft Determination D4 and Draft Determination D5:

- is inconsistent with the views expressed by the courts (including the statutory fictions created by Division 6);
- is inconsistent with the statutory context and purpose of s 99B;
- is inconsistent with the language and purpose of the entire tax legislation, including the conduit approach to the taxation of trusts;
- is inconsistent with the policy principles underpinning the taxation of trusts; and

- results in unfair outcomes, including the denial of the capital gains tax discount and the ability to offset capital losses against capital gains in respect of certain resident investors (who would otherwise obtain such entitlement under the tax rules).

These matters are discussed further below**.**

Residency assumption

The assertion expressed by the Commissioner in Draft Determination D4 that the residency assumption in s 95(1) does not apply for the purpose of s 855-10, is inconsistent with the views expressed by the Full Federal Court (Middleton, Perram and Dodds-Streeton JJ) in *Howard v Commissioner of Taxation* [2012] FCAFC 149 (**Howard**).

The Full Federal Court in *Howard* affirmed the view, expressed by the High Court in the *Union Fidelity* case, that the statutory fictions created by Division 6 (in that case, a hypothetical treatment of a non-resident trust as an Australian resident) are carried through for the purpose of assessment for the entire tax legislation (paragraphs 40 – 49):

> 40. There, having grasped the initial hypothetical transformation of the Esparto Trust estate into a resident taxpayer, one is now required (as part of that hypothesis's inevitable working through) hypothetically to treat the Juris Trust estate as a resident taxpayer and to ask whether the amounts received by it would have been included in such a resident taxpayer's assessable income.
> ….
> 49. …It is true, no doubt, that s 95 is not the same as s 99B(2)(a) and it is certainly correct that Div 6 has received many amendments since the time of Union Fidelity. But the basic point it illustrates remains sound: **Div 6, and its various hypothetical taxpayers, operate on an assumption that the fictions thereby engendered are to be assessed for tax under the balance of the Act**. Mr Howard's submission that statutory fictions must be closely confined to the domain of their operation is, of course, correct. The difficulty, however, lies in the fact that that domain in the case of Div 6 generally, and in the case of s 99B(2)(a) in particular, is the whole Act. Once that is accepted, Mr Howard must be brought to s 44(1) on the hypothesis demanded by s 99B(2)(a) and no other; i.e., there must be an assessment of whether a resident taxpayer who derived the amounts received by the Juris Trust estate would have been required to include the amounts in its assessable income. Once that is accepted, s 44(1), together with s 159GZZZP(1), take their inevitable course and s 99B(2)(a) conveys that result through the overlying layers of trusts back to Mr Howard. That is the end of the matter. (emphasis added)

It follows from the Full Federal Court decision in *Howard* that the residency fiction in subsection 95(1) is carried through for the purpose of assessment for the whole of the tax legislation, and applies for the purpose of section 855-10.

Catch-all provision

The Full Federal Court in *Howard* re-affirmed the view that section 99B was introduced as a 'catch-all' provision, with residual effect after the primary operation of section 97:

> 51. …It is not necessary for us to do so because whatever is not included under s 97 will, by reason of the foregoing conclusion, be included by the necessary operation of s 99B(2)(c). **That provision is a catch-all** and, if necessary, as such is apt to catch the whole of the distribution to Mr Howard even if it be not brought to tax under s 97. It is likely, however, that Mr Howard's argument about the operation of s 97 likewise proceeds in disobedience to the similar express hypothesis demanded by s 99B(2). (emphasis added)

The statutory construction of s 99B as a residual, catch-all provision has implications for Australian resident investors taxed on a present entitlement basis under section 97. In particular:

- Australian resident investors which invest offshore through a non-resident trust, and assessed on a present entitlement basis in respect of that non-resident trust, will not be subject to the operation of s 99B (pursuant to the carve-out in s 99B(2)(c)); and
- there should be no residual operation of s 99B, given that the amounts would already be taxed in Australia. This outcome is consistent with the legislative purpose of s 99B as a catch-all provision as outlined above.

Section 99B and capital gains tax

The Commissioner expressed the view in paragraph 9 of Draft Determination D5 that "An amount attributable to the capital gain may nonetheless be assessable to the beneficiary under subsection 99B(1) of the ITAA 1936."

The intention of Parliament in relation to capital gains (exempt from tax when s 99B was introduced into the tax regime) is described in the Explanatory Memorandum to *Income Tax Assessment Bill (No 5) 1978* (which introduced section 99B – see page 28 of the Explanatory Memorandum):

> Proposed <u>sub-section (2)</u> modifies this general rule and will have the effect that the amount to be included in assessable income under sub-section (1) is not to include anything that represents either –
> …
> - amounts - such as capital gains, or ex-Australian income taxed abroad and exempt from tax under section 23(q) of the Principal Act – that would not be included in assessable income if derived by a resident taxpayer (paragraph (b))…

Relevantly, since the introduction of the capital gains tax regime in 1985, in the ordinary case, there would be no need for s 99B to be triggered, given that such amounts would already be taxed in Australia through the combined operation of the capital gains tax rules and Division 6.

Presumably it is not the purpose of s 99B to override specific (and subsequent) CGT exemptions (such as that provided for life policies under Item 3 of the Table in s 118-300(1) in respect of life policies held by trustees, and the flow-on exemption for beneficiaries of that trust under s 118-300(1A)).

Similar observations may be applicable to the small business CGT concessions. If a CGT concession is available under Division 152 to a resident individual where he or she receives a distribution from an Australian trust then it should also apply to a resident individual who receives such a distribution from a non-resident trust.

We consider the better course of action to be to withdraw the Draft Determinations. However, if contrary to that they were finalised, the Determinations should confirm that CGT exemptions that would apply to resident taxpayers are not disregarded when applying s 99B.

Nature of amounts assessable under s99B

Even if it were correct to treat amounts of capital gains that are assessable to beneficiaries pursuant to s 99B as assessable income other than a discount capital gain (which it is not), applying the beneficiary-centric approach described under heading 2.1 above should result in an appropriate amount of assessable income in the beneficiary's hands. For example, a resident individual beneficiary receiving a distribution out of trust corpus representing a previously accumulated capital gain should be assessable on the same amount that they would have been assessable on had they made the capital gain personally.

Policy considerations

The main policy principle underlying the taxation of trusts is that there should not be significant distortion between the tax outcomes as between direct and indirect investment: refer to Policy Principle 1, as articulated by the Board of Taxation in its Discussion Paper, *Review of Tax Arrangements Applying to Managed Investment Trusts* dated October 2008, as follows:

> 1.6 The broad policy framework for the taxation of trusts is to tax the beneficiary on its share of the net income of the trust, so that the trustee is only taxed on income that is not taxable in the hands of beneficiaries. Within this framework, the Board should ideally develop options for reform with taxation outcomes that are broadly consistent with five key policy principles:
>
> *Policy Principle 1*
> The tax treatment for trust beneficiaries who derive income from the trust should largely replicate the tax treatment for taxpayers as if they had derived the income directly."

In addition, a policy goal governing the tax rules relating to outbound investments is that tax distortions, between direct and indirect offshore investments, should be removed to ensure a competitive framework within the Australian managed funds industry. This policy principle was articulated in the Supplementary Memorandum to *Taxation Laws Amendment Bill (No.4) 1998* as follows:

> 1.28 If an exemption were not provided, direct investments in REITs may be treated more favourably than indirect investments in REITs managed by Australian collective investment funds. This is because the indirect investments would continue to be subject to accruals taxation under the CFC measures whereas direct investments are likely to be exempt from accruals taxation following the proposed exemption from the FIF measures for US FIFs. Indirect investments would therefore continue to be subject to additional tax and compliance cost burdens associated with accruals taxation while direct investments in REITs would no longer be accruals taxed under the FIF measures.
>
> 1.29 Less favourable treatment of REITs managed by Australian collective investment funds could have a significant impact on their ability to compete. In this regard, direct investments in REITs are a close substitute for indirect investments in REITs managed by Australian funds.
> …
> 1.41 The implementation option is considered the only effective means of achieving the policy objective of ensuring that Australian collective investment funds remain competitive with US funds in attracting and managing Australian investment in REITs without giving rise to significant tax deferral opportunities. The option is expected to lead to an overall reduction in compliance costs for Australian collective funds that manage REITs.

The Commissioner's view in Draft Determination D4 and Draft Determination D5 cannot be sustained since it contravenes the above policy principles for the following reasons:

- certain taxpayers, who are eligible for the capital gains tax discount in respect of direct ownership of foreign assets, would not be entitled to the capital gains tax discount if the investment were made through a foreign trust; and

- there would be distortions between the tax outcomes under a direct and indirect investment in foreign assets.

Need for legislative amendment

We note the Commissioner's concern expressed in paragraph 19 of Draft Determination D5 that resident companies might be able effectively to benefit from the application of the CGT discount and agree that this would be an inappropriate outcome. However, we consider that *Alternative View 2* described in paragraphs 24 to 27 of Draft Determination D5 to present an approach which would produce an outcome more consistent with the policy inherent in Division 115 described above in response to Draft Determination D4.

In the absence of applying a beneficiary-centric approach such as that described in *Alternative View 2*, the possible ability of a corporate beneficiary effectively to benefit from the CGT discount is an inappropriate outcome and should properly be addressed by legislative amendment instead of administrative treatment by the Commissioner.