

JOINT SUBMISSION BY

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

Draft Taxation Determination 2016/D6: where an Australian corporate tax entity is a partner in a partnership, can the partnership 'hold' a direct control interest (within the meaning of section 350 of the Income Tax Assessment Act 1936) in a foreign company for the purpose of Subdivision 768 A of the Income Tax Assessment Act 1997 (TD 2016/D6)

and

Draft Taxation Determination 2016/D7: where an Australian corporate tax entity is a beneficiary of a trust, can the trust be taken to 'hold' a direct control interest (within the meaning of section 350 of the Income Tax Assessment Act 1936) in a foreign company for the purpose of Subdivision 768 A of the Income Tax Assessment Act 1997 (TD 2016/D7)

Date due: 6 February 2017

The Professional Bodies welcome the opportunity to comment on the two draft Tax Determinations (Draft Determinations) TD 2016/D6 and TD 2016/D7. The Draft Determinations consider whether an Australian corporate tax entity that is a partner in a partnership or a beneficiary of a trust can be taken to 'hold' a direct control interests (within the meaning of s 350 of the *Income Tax Assessment Act 1936* (ITAA 1936)) in a foreign company for the purpose of Subdivision 768-A of the *Income Tax Assessment Act 1997* (ITAA 1997).

We have prepared a combined submission on the two Draft Determinations as there are some common issues, and also some differences which can be better contrasted and considered in a combined submission. We also provide separate comments for each draft determination in the specific comments section below.

GENERAL COMMENTS

The interpretations and approaches adopted in the Draft Determinations provide workable solutions on the application of the Subdivision 768-A dividend exemption for foreign non-portfolio dividends received by an Australian resident company through interposed structures.

The TD 2016/D6 interpretation is appropriate where that company is a partner in a partnership that has an interest in the foreign company that has paid the dividend.

However the TD 2016/D7 interpretation is problematic and appears unfair in relation to the application of the Subdivision 768-A dividend exemption for foreign non-portfolio dividends received by an Australian resident company, where that company has an interest in the foreign company that has paid the dividend as a beneficiary of a trust.

The effective dates for determining whether there is a participation interest in respect of indirect holdings are different for holdings through a partnership (test at time of dividend) and trusts (test by reference to trust income for the year or at the end of income year (for corpus) which is deemed to apply at the time of dividend).

The Professional Bodies note that the conclusion in TD 2016/D7 ends up with a test time by reference to a long period rather than the quite clear words of section 768-5(2)(d) which is intended to be by reference to a point in time.

The Professional Bodies recommend that the test time should be highlighted in each Draft Determination to avoid readers misunderstanding the differences.

The TD 2016/D7 position for trusts is problematic for all trusts but is particularly challenging (and some may argue unfair) for fixed trusts with semi-annual distributions (or more frequent distributions in a year) when compared to the partnership approach where trust interests are sold ex-distribution before the end of the income year. The Professional Bodies recognise that ATO interpretations for trusts might be restricted by a law design compromise in ITAA 1936 to deal with the treatment of both fixed interests and also discretionary interests (biased towards the latter). But as noted below the Professional Bodies:

- a) Would urge the ATO to review its application of statutory interpretation principles to consider if another more equitable outcome can be achieved; and
- b) If the ATO can not reconsider its application of statutory interpretation principles in this context, to initiate immediately a consideration of interpretative and/or administrative approaches that could be taken by the ATO to potentially mitigate adverse outcomes for trusts with fixed interests.

These two drafts arise from the temporary ATO Subdivision 768-A consultation working group (“working group” – [link to ATO website](#)) involving the ATO and professions, established to consider the dividend exemption for foreign non-portfolio dividends received by an Australian resident company in Subdivision 768, which have given rise to various interpretative and administrative issues. The Professional Bodies appreciate the ATO establishment of the working group to enable various interpretative and administrative issues in relation to the new Subdivision 768-A to be identified, prioritised and resolved on a holistic basis. The working group consultation process to date has also led to draft Tax Determination TD 2016/D2 (meaning of ‘at the time the distribution is made’ when applying the participation test for the purpose of Subdivision 768-A).

The Professional Bodies submit that the ATO should continue to progress, on a timely basis, the remaining 768-A issues identified by that working group: some of these have been outstanding for quite some time.

If the ATO cannot reconsider its application of statutory interpretation principles to TD 2016/D7, the working group can assist the ATO to initiate alternative administrative approaches that could be taken by the ATO to potentially mitigate adverse outcomes for trusts with fixed interests.

SPECIFIC COMMENTS APPLICABLE TO BOTH DRAFT DETERMINATIONS

Cross references to other 768-A ATO rulings would be desirable

The ATO’s proposed draft guidance released on the various Subdivision 768-A issues to date is important and useful, including working through multi-tiered ownership structures.

We submit however that taxpayers, advisers and other stakeholders would benefit from each of the Draft Determinations having clear cross references to this other related guidance. In particular, the key concept of ‘at the time the distribution is made’ is covered in the ATO’s Draft Ruling TR 2016/D2, which sets out the ATO’s view of the meaning of ‘at the time the distribution is made’ when applying the participation test for the purpose of Subdivision 768-A. That ruling provides some important guidance on whether particular interests may be taken into account at a particular time, and ideally should be considered by taxpayers when applying each of the Draft Determinations.

We would also suggest a clearer marker to the ‘at the time the distribution is made’ in all the examples, as discussed below, before the final conclusion is reached in each example, to ensure that all readers understand the analysis.

Further, each Draft Determination should provide a suitable cross reference to the other tax determination. Furthermore, it would be desirable for each Draft Determination to briefly highlight that the effective dates for determining whether there is a participation interest in respect of indirect holdings is different for holdings through a partnership and trusts (i.e. to avoid inadvertent erroneous assumptions that a similar treatment applies to both partnerships and trusts).

Date of effect

The decision to make the Draft Determinations retrospective from the date that Subdivision 768-A of the ITAA 1997 commenced (distributions made on or after 17 October 2014), should be appropriate for most cases under the Draft Determinations.

SPECIFIC COMMENTS - PARTNERSHIPS – TD 2016/D6

Clarifying meaning of “partnership”

TD 2016/D6 could be clearer on the reference to the interposed “partnership” and that the guidance covers the tax law definition of partnership as defined in section 995-1 of the ITAA 1997.

SPECIFIC COMMENTS - TRUSTS – TD 2016/D7

The need to review the conclusion about the trust participation test time for fixed trusts

The TD 2016/D7 is problematical because in our view the focus on the "year-end" position is inconsistent with the approach to participation test time in respect of interposed partnerships and companies (which focuses on a point in time). Nor does it align with the taxation of trust regime in Division 6 of the ITAA 1936 (that determines who is taxed on the foreign dividend income of the trust).

In relation to the first concern, the Professional Bodies draw attention to these clear words in s.768-5:

“768-5 Foreign equity distributions on participation interests
*Foreign equity distributions received **through interposed trusts and partnerships***

- (2) An amount is not assessable income, and is not * exempt income, of an entity if:
- (a) **the entity is a beneficiary of a trust** or a partner in a partnership, an Australian resident and a * corporate tax entity; and
 - (b) the amount is all or part of the * **net income of the trust** or partnership that would, apart from this subsection, be included in the entity's assessable income because of:
 - (i) Division 276; or
 - (ii) **Division 5 or 6 of Part III of the Income Tax Assessment Act 1936** ; and
 - (c) the amount can be attributed (either **directly or indirectly through one or more interposed trusts** or partnerships that are not * corporate tax entities) to a * foreign equity distribution; and
 - (d) **at the time the distribution is made, the entity satisfies the participation test** in section 768-15 in relation to the company that made the distribution; and
 - (e) (not relevant) **(emphasis added)**

The Professional Bodies note that:

- (a) The statute is quite clear in applying its mechanism to trusts and in applying the participation test to a point in time test; and
- (b) The statute is unambiguous in referring to those taxpayers which have included foreign dividend income by virtue of Division 6 of the ITAA 1936.

The Professional Bodies note that, given this clarity of legislation that the draft TD should not issue without a much stronger consideration by the ATO of the principles of statutory interpretation involved here to align the TD analysis of the test to these two aspects of s.768-5.

In relation to fixed trusts, we submit that the TD as currently drafted, which determines a participation interest by reference to an overall share of income or right to corpus of the trust at the end of the year (per s.351(2)) is not ideal in light of the above two aspects of s.768-5.

An approach that would achieve the above two focusses of s.768-5 would be, for fixed trusts, to test the beneficiary's interest in the particular dividend income to which it has been made presently entitled under the trust deed and this is submitted to give a more appropriate result. The alignment with

present entitlement (and Division 6) would also better reflect the true (indirect) participation interest of the beneficiary (which has (indirectly) received and is therefore taxed on the dividend income of the foreign company) seeking to claim the exemption in s.768-5.

Therefore we would request the ATO to consider potential actions to:

- a) At minimum, escalate and retest its TD 2016/D7 interpretation
- b) Introduce a trust interpretive approach for fixed trusts that appropriately aligns the participation interest of the beneficiary to the beneficiary's rights under the trust deed in respect of the dividend income (eg, presently entitled share of the dividend income and not the total trust income of the year).
- c) And further to allow for trusts making interim distributions eg. half-yearly or quarterly, by allowing the testing to occur by reference to the presently entitled share of the dividend income for the period relating to the interim distribution.
This would overcome the manifestly unfair outcome proposed in example 5. It would mean that the interim distribution of foreign dividends, at a time when the relevant unitholder held 25% of the trust interest and 17.5% of the underlying interest in the foreign company, would satisfy the participation test.

The Professional /bodies submit that the Commissioner has ample administrative powers under the current law to adopt these approaches.

Further comments if the outcome of TD 2016/D7 is not changed after review

If, despite our abovementioned comments, the review of TD 2016/D7 results in the ATO maintaining the current outcome in TD 2016/D7, the Professional Bodies make further comments.

We submit that the TD should have a much clearer initial statement that the test for the beneficiary's participation interest looks to the beneficiary's interest at the end of the year of income notwithstanding the legislative provision in section 768-5(2)(d). The current analysis does not allow the reader to properly understand this key proposition until paragraphs 57 and 58, late in the Explanation section.

The paras 57-58 analysis is then made and explained without reference to the sharp inconsistency of outcome of that analysis when compared with the clear language of s.768-5.

Further, if the outcome of TD 2016/D7 is not changed after review, we submit:

- a) that paragraph 1 of the determination should have an additional clause added along the lines of "the direct participation interest is calculated in accordance with section 960-190(1) Item 2 and section 351(2) of ITAA 1936."
- b) in each example it would help to insert words along the lines of "The analysis requires testing the direct control interest at the end of the year of income" This might be inserted at the start of paragraphs 7, 14, 23, 31 and 42.
- c) paragraph 58, which explains this key concept including (at paragraph 61) that it applies to fixed as well as discretionary trusts, should be promoted to the front of the Explanation, or alternatively there should be a subheading inserted along the lines of "The direct control interest for trusts is calculated by reference to the percentages at the end of the year of income and by reference to the terms of the trust deed."

In addition, the analysis of why this provision has ascendancy over the clear words of section 768-5 should be provided.

If the outcome of TD 2016/D7 is not changed after review, highlighting and mitigating pitfalls for disposals of trust fixed interests ex-distribution – a significant defect in the implementation and administration of Division 768-A results, which requires urgent ATO or legislative action.

If the outcome of TD 2016/D7 is not changed after review, the draft TD 2016/D7 highlights the ATO interpretation that the effective date for determining whether there is a participation interest in respect

of indirect holdings held through a trust requires consideration of income/capital entitlements at the end of income year which is then deemed to apply at the time of dividend.

The examples show that the position for interposed trusts with present entitlements determined more regularly than annually is problematic where trust interests are sold or acquired ex-distribution before the end of the income year.

We see that that the ATO analysis portrays this as the clear outcome of section 351(2) of ITAA 1936, as outlined in the Explanation at para 61.

Even if this “year-end” participation test time might be appropriate in relation to discretionary trusts, we highlight that this interpretation is at odds with the approach of Division 768-A, inconsistent with the approach to participation test time in respect of interposed partnerships and of companies and in a case where for fixed trust interests are sold/acquired during a year, does not necessarily allow those beneficiaries who are actually taxed on the dividend income to be attributed with the requisite indirect interest to claim the relief under Div 768-A.

The Professional Bodies are concerned that this will be an impediment to managed funds and fixed trusts holding investments in foreign companies and achieving the Division 768-A desired outcomes.

Therefore we would request the ATO to consider potential actions to retest this interpretation for fixed trusts or to have a fixed trust interpretive approach that aligns the eligibility test for the Division 768-A exemption with those beneficiaries who are present entitled to (therefore taxed on) the trust distribution that included the foreign company dividend.

As noted earlier, this would align the testing to the present entitlement calculations of the dividend income for the period relating to the interim distribution. So in example 5. It would mean that the interim distribution of foreign dividends, at a time when the relevant unitholder held 25% of the units in the unit trust and 17.5% of the underlying interest in the foreign company, would satisfy the participation test.

If there is no alternative approach for fixed trusts to resolve this issue then:

- a) We submit this issue should be logged as a technical correction issue. We would be pleased to work with the ATO to log this for attention with Treasury or with the Board of Taxation –the ATO Div 768-A working group could work on this proposition, or
- b) This issue should be escalated for consideration under the Commissioner’s remedial power when that is eventually legislated.

Corrections

We note that there are some typos in the examples. The trust examples are intended to outline an ownership interest at the start of the year, changes in the year and the end of year position used for testing. We submit therefore that:

- At para 17 the 1 July 2015 date should be 1 July 2014, the start of the 2015 income year
- Ditto para 25.