TD 2017/23EC - Compendium

Public advice and guidance Compendium – TD 2017/23

This is a compendium of responses by external parties to draft Taxation Determination TD 2016/D4 *Income tax: does the residency assumption in subsection 95(1) of the Income Tax Assessment Act 1936 apply for the purpose of section 855-10 of the Income Tax Assessment Act 1997, which disregards certain capital gains of a trust which is not a resident for CGT purposes?*

This compendium of comments has been edited to maintain the anonymity of entities that commented.

Summary of issues raised and responses

Issue No.	Issue raised	ATO Response/Action taken
1	**The residency assumption applies broadly.** The residency assumption in subsection 95(1) of the *Income Tax Assessment Act 1936* (ITAA 1936) should be given its full intended application. The legislative intention of the residency assumption is to ensure that the net income captures the whole of the trust's taxable income. It is intended to apply for the balance of the tax legislation, including Division 855 of the *Income Tax Assessment Act 1997* (ITAA 1997). This is supported by the Full Federal Court decision in *Howard v. Commissioner of Taxation* [2012] FCAFC 149, where the general residency assumption in section 99B of the ITAA 1936 (which applies to all forms of income) took precedence over the specific rule in subsection 44(1)(b) (which sought to tax non-residents only in respect of dividends paid out of Australian sourced profits). On one view, section 95(1) is a more specific provision when calculating the net income of a trust estate and should take precedence over section 855-10 of the ITAA 1997.	Disagree. The purpose of subsection 95(1) is to render source irrelevant, consistent with the mischief addressed following *Union Fidelity Trustee Company Australia Limited v. Federal Commissioner of Taxation* [1969] HCA 36. Section 855-10 on the other hand is making clear that only certain assets are potentially subject to tax when owned by a non-resident trustee. To the extent there is a potential overlap between the two provisions, section 855-10 in our view would be more specific, and would have no sensible scope of operation if the residency assumption prevailed (see issue 3 below). We consider that the decision in *Howard* offers no support for the contrary view. Indeed, it provides an example of a specific rule in section 99B prevailing over a general rule regarding source of dividends.
2	The overlap between section 855-10 of the ITAA 1997 and subsection 95(1) of the ITAA 1936 can be resolved borrowing the 'separate and different context' approach applied by the majority	Disagree. Section 855-10 is designed to limit the range of assets on which non-residents are subject to tax in Australia. Section 855-10 operates to disregard non-TAP (*taxable*

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	of the Full Federal Court in *Financial Synergy Holdings v. Commissioner of Taxation* [2016] FCAFC 31 at [30-39].	*Australian property*) capital gains and capital losses of non-residents, including non-resident trustees, with the consequence that such gains or losses would not subsequently be included in the calculation of subsection 95(1) trust net income.
3	The alternative view is the better view. Section 855-10 of the ITAA 1997 only applies if the trustee is assessed (for example, under sections 98, 99, and 99A of the ITAA 1936). While logically the disregarding of a capital gain occurs before the calculation of a net capital gain, there are other instances where there are similar quandaries with the operation of Division 6 of Part III of the ITAA 1936 – for example in the interaction with Division 11A of the ITAA 1936.	Whilst the observation regarding the interaction with Division 11A is noted, the ATO considers a linear logical approach applies in this context. Section 855-10 operates to disregard a capital gain (or capital loss) from a CGT event and does not operate to disregard a net capital gain. It is the net capital gain that is included as assessable income in the calculation of subsection 95(1) trust net income to which a trustee may be assessed under sections 99 or 99A of the ITAA 1936. The Commissioner disagrees with this interpretation for the reasons provided in the Taxation Determination [paragraphs 18 to 20] which include that the disregarding logically occurs prior to the net capital gain (or assessable income for subsection 95(1)) being determined. It is this amount in relation to which beneficiaries or trustees (including sections 99 or 99A) are subject to assessment.
4	In the absence of a broader Division 6 review, the Commissioner could seek to apply statutory remedial power to ensure that Division 6 and other provisions can be administered in a way that achieves their intended purpose.	The matter does not satisfy the Remedial Power criteria.
5	It does not appear to be the legislative intention that section 855-10 of the ITAA 1997 apply in calculating a foreign trust's net income. If the Commissioner's position is a correct interpretation of the law, the law needs to be amended. We encourage the Commissioner to refer the matter to Treasury with a recommendation that the law be rectified retrospectively.	Disagree. We cannot identify evidence of such a legislative intention, nor is it clear to us that the law needs to be amended. In our view, subject to the possible operation of foreign accrual provisions, section 855-10 provides a clear rule which limits both the range of CGT asset gains and losses for a foreign trust and its Australian tax compliance costs. That was the evident purpose of

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		the rule in predecessor provisions at the time CGT commenced (that is, sections 160L and 160T of the ITAA 1936), and remains valid notwithstanding the narrower range now of such assets. That the rule had a focus on 'inward' investment is illustrated by the fact that the residence of any beneficiaries (assuming them not to be absolutely entitled) is not part of the enquiry. However, the section necessarily has a broad application in circumstances of both inward and outward investment. When viewed from the perspective of 'outward' investment by residents through foreign trusts, which may be more significant now than in previous years (especially at a fund level) other policy considerations are naturally raised, including neutrality between direct and indirect investment, and between resident funds investing on-shore as opposed to offshore. But even with an 'outward' investment focus, full residence-equivalent taxation under a section 95 residency assumption could affect resident beneficiaries differently depending on how they are placed, for example, whether there is any opportunity to defer distributions and/or whether relevant information can be obtained to do Australian CGT calculations. Desired outcomes for resident beneficiaries may also be at odds with the clear and straightforward outcomes intended for foreign investment as discussed above. Indeed, over time and taking into account different taxpayer perspectives, different views have been expressed about the way the law should work. We note that an amendment proposed as part of the repeal of the FIF provisions to section 855-10 (which would have removed the interaction with the section 95 net income definition) did not proceed following industry submissions. The matter has been raised with Treasury again in light of the comments made in relation to the draft Tax Determination.

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6	The term 'foreign trust for CGT purposes' was inserted as a replacement for previous terminology. There is no indication that the reference to foreign trust for CGT purposes was included with the intention to override the residency assumption in subsection 95(1). Rather the reference to a 'foreign trust' is made merely due to the existence of a separate definition of foreign trust for CGT purposes which renders the term foreign resident alone in section 855-10 insufficient to cover all entities to which the section could apply. Further support can be found in section 855-40. If it was intended that section 855-10 was to override the residency assumption in calculating the net income under subsection 95(1), it should follow that section 855-40 should be restricted to fixed trusts that are resident trusts – yet it is not restricted in this way.	Disagree. The issue did not arise as a consequence of the introduction of the definition of foreign trust for CGT purposes. There has been an exemption for trustees of trusts other than Australian trusts for assets that were not taxable Australian property since CGT was introduced, – see for example, subsection 160L(2) of the ITAA 1936. We don't consider it necessary that section 855-40 of the ITAA 1997 should say specifically that it applies only to resident trusts. Because section 855-10 of the ITAA 1997 excludes non-TAP capital gains from a foreign trust's net income, section 855-40 of the ITAA 1997 can only have practical application to resident trusts.
7	On the Commissioner's view it should follow that section 855-10 of the ITAA 1997 should also be considered more specific and therefore override the residency assumptions in section 383 and Division 6AAA of the ITAA 1936. This would be an absurd result and undermine the integrity of Australia's tax system.	Disagree. The CFC and Transferor Trust regimes were introduced to deal with the more specific treatment of 'controlled' foreign entities and prevent avoidance of tax by residents so the residency assumption there is more specific. Also, due to this 'control', beneficiaries would more likely have access to relevant information such as would enable them to calculate net capital gains under Australian CGT rules.
8	The Transferor Trust rules contain a specific residency assumption in respect of general modifications to the CGT rules under paragraph 102AAZB(b) of the ITAA 1936. This modification only appears to apply to Parts 3-1 and 3-3 of the ITAA 1997, and therefore should not extend to encompass Division 855 of the ITAA 1997.	Noted. It appears that a consequential amendment might have been missed when the foreign resident CGT provisions in Division 136 of the ITAA 1997 were moved out of Part 3-3 into Part 4-5 as Division 855. However, whatever the effect of this state of affairs for the application of the transferor trust rules, the presence of the specific residency assumption is a strong indicator that the residency assumption in section 95 was not thought to override the predecessors to section 855-10.

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9	We do not agree with the position in paragraph 19. Foreign beneficiaries of a non-fixed trust should only be taxed on their share of gains from non-TAP to the extent the gains are Australian sourced pursuant to the limitations of subsection 98(2A) of the ITAA 1936. In the event such a non-TAP gain is attributed to sources in Australia, subsection 98(2A) would consequently apply to assess the trustee of a *non-fixed* foreign trust on the gain whereas subsection 855-40(3) of the ITAA 1997 would apply to render trustees of *fixed* trusts not liable to tax in respect of the gain.	This paragraph has been excluded from the final Determination as it raises a separate issue. We are developing a taxation determination that considers the relevance of the source concept in Division 6 of Part III of the ITAA 1936 following the 2011 streaming amendments to Subdivision 115-C of the ITAA 1997.
10	**Administrative Burden** Disagree with paragraph 20 in that the alternative view creates unnecessary administrative burden. Keeping accurate records of worldwide assets would not pose any significant additional burden than the Division already requires for other income. 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.	A proposed amendment to remove the exemption for trustees from section 855-10 (in Exposure Draft Tax Laws Amendment (Foreign Source Income Deferral) Bill (No. 1) 2010) did not proceed. Submissions on the draft were critical of the compliance burden that would be imposed if trustees of non-resident trusts had to include gains and losses from non-TAP assets in their net income calculation. We note that capital gains record keeping requirements are more onerous than for other types of income because of the way capital gains are taxed in Australia. In the case of a beneficiary with no real ‘control’ of such a foreign trust, the beneficiary may not be able to compel the Trustee to disclose information sufficient to calculate their taxation liability. Also, the ATO would have difficulty obtaining the information necessary to confirm the character and quantum of any gain.
11	**Inconsistent with policy** The broad legislative intent is that foreign trusts should be subject to the same rules as Australian trusts. The proposed Asia funds passport arrangement is based on the assumption that the	There is no reason why foreign trusts should necessarily be treated in all respects in the same way as resident trusts. For example where there is a trust with thousands of non-resident beneficiaries and only a few residents it is not appropriate that the

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	underlying treatment for an Australian resident should be the same irrespective of whether they invest through an Australian or foreign trust. Where trustees of foreign trusts have taken steps to distribute capital gains rather than accumulate, it is unfair to deny Australian resident beneficiaries CGT treatment simply because the assets were held by a foreign trust. Particularly as the mechanism by which the conclusion is reached lies in a concessionary provision designed to limit the range of assets on which non-residents are subject to tax in Australia.	trust have to keep records in accordance with Australian CGT rules. And the rules that have specified a list of CGT assets in the CGT tax base of foreign trusts were never expressed to be subject to the residency status of particular beneficiaries (other than those absolutely entitled).
12	**Unintended extension of exemption to non-fixed foreign trusts** The Commissioner's interpretation provides an exemption for foreign resident beneficiaries of non-fixed foreign trusts which exceed the scope intended by Parliament.	Disagree. Foreign resident beneficiaries of *foreign* trusts, regardless of whether the trust is a fixed or non-fixed trust, were not intended to be taxable on non-TAP capital gains. The amendments which were made to distinguish between beneficiaries of fixed and non-fixed trusts were focussed on resident trusts.
13	**Character flow-through** The Commissioner's interpretation is inconsistent with the flow-through tax treatment of trusts by taxing Australian beneficiaries on revenue account in relation to a capital gain derived by a foreign trust. Consequently it gives rise to an unintended disincentive to indirect foreign investment by Australian residents. The better construction of the interaction of Division 6 of Part III of the ITAA 1936, Subdivision 115-C of the ITAA 1997 and section 855-10 of the ITAA 1997 is that Australian beneficiaries should be subject to the CGT provisions of Subdivision 115-C in relation to capital gains on non-TAP derived by foreign trusts to which they are presently entitled. In particular, the words of section 115-215 of the ITAA 1997 are noted 'the trust estates	Disagree that a general flow through principle applies in relation to the taxation of trusts. *Charles v. FCT* [1954] HCA 16 is often cited as authority for the view that income retains its character as it passes through a trust to beneficiaries. At best, *Charles* said that capital (corpus) in the hands of the trustee may be capital (corpus) in the hands of the beneficiary. It says nothing about statutory amounts or any other amounts for that matter. More specifically, the issue of statutory character flow-through was considered in *FC of T v. Greenhatch* [2012] FCAFC 84, where the Full Federal Court found that absent any specific rules elsewhere in the Tax Acts, the proportionate share of trust net income included in the assessable income of a beneficiary (or assessed to a trustee), has no character beyond that inherent in

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	capital gains are treated as a beneficiary's capital gain'. This provides for character flow-through and taxes Australian investors on capital gains made on non-TAP assets regardless of whether they hold them directly or indirectly through a foreign trust.	the share of net income as being a proportionate share of *all* of the net income [see Decision Impact Statement *Greenhatch* v. *Commissioner of Taxation* [2013] HCA Trans 104]. Where an amount is assessed under section 99B of the ITAA 1936 no character is attributed to it. See TD 2017/24.
14	It is not clear from the example whether the same approach would apply if the amount was distributed in the same year as the shares were sold.	Changes have been made to paragraphs 4 and 6 to remove the timing references as they are not relevant to the issue.
15	The draft taxation determinations TD 2016/D4 and TD 2016/D5 *Income tax: Where an amount included in a beneficiary's assessable income under subsection 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 trust, 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?* appear to jump to the conclusion that on distribution of a non-TAP capital gain of a foreign trust to an Australian resident, section 99B of the ITAA 1936 may apply to include the full amount in the beneficiary's assessable income. This is where the reasoning in the *Examples* seems incomplete and the facts unclear. For example, TD 2016/D4 refers to a discretionary trust whilst TD 2016/D5 simply refer to a foreign trust. Neither ruling refers to the beneficiary being presently entitled to the trust income.	The reference to a 'discretionary' trust in the *Example* has been removed, as the trust's status as either a fixed trust, or non-fixed trust is irrelevant. The 'present entitlement' of a beneficiary to income is also irrelevant in the circumstances described, because it is only relevant in working out a beneficiary's share of net income.