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Attention: Michael Bradshaw

Dear Michael

Discussion paper – Division 6 - improving the taxation of trust income

Thank you for the opportunity to provide the industry's views on Treasury's Division 6 discussion paper "*improving the taxation of trust income*".

The Property Council is the peak body representing the interests of owners and investors in Australia's $400 billion property investment sector.

This submission follows on from the discussions at the meeting on 16 March 2011 with industry and professional bodies.

Our recommendations are:

1. the definition of the "income of the trust estate" in Division 6 of Part III of the *Income Tax Assessment Act 1936* should not be changed for unit trusts where the tax on the net income of the trust estate is paid by the beneficiaries who receive the economic benefit of the trust's income and gains: and
2. it is appropriate to consider allowing streaming of certain types of income to beneficiaries provided that the tax on the net income of the trust estate is paid by the beneficiaries who receive the economic benefit of the trust's income and gains.

This requires the current definition of the term "the income of the trust estate" (being the distributable income as defined in the trust deed) to remain for unit trusts that meet the criteria in recommendation 1. This is because trust beneficiaries are taxed appropriately. The beneficiaries receive the economic benefit of a property trust's income and gains, either directly by a cash distribution or indirectly by an increase in the value of their property trust investment.

The proposed changes will jeopardise both the value of a beneficiary's investment in a property trust and the trust's ability to manage its funds.

As detailed below, retaining the current position (at least for entities that qualify as MITs) is also consistent with the approach being proposed in relation to the attribution regime. We see no reason to impose a different outcome given that these rules will come into effect soon.

The proposed options

All three proposed options for determining distributions will force MITs to distribute all their capital gains, or potentially face penalty tax rates. This is simply not practical for a property trust and conflicts with established market distribution practices.

It will mean that many property trusts may not be able to hold enough money to manage the trust or reinvest.

Current Practice

Accepted industry practice is that property trusts determine distributable income by reference to operating profits excluding capital gains.

The taxable income of the property trust is separately calculated in accordance with the provisions of the tax law and includes net capital gains. Beneficiaries receive their share of the distributable income and include their share of the property trust's taxable income in their assessable income.

An illustrative example of how the current practice operates is attached.

Proposed MIT Regime

The proposed MIT Regime is intended to maintain and build on the current practice by:

- providing an attribution regime which separates cash distributions from allocation of taxable income;
- specific recognition that cash distributions may be less than taxable income and any corresponding cost base increases; and
- allowing streaming of capital gains to redeeming investors.

Bring forward increase in cost base adjustments

Under current law where a beneficiary's cash distribution exceeds their share of the trust's taxable income there is a cost base reduction. However, where the cash distribution is less than the taxable income there is no cost base increase.

The cost base should increase in these circumstance. It is proposed that the MIT Regime will remove this anomalous outcome.

Consistent with the Minister's announcement to reduce anomalous outcomes, for consistency, we recommend that the provisions allowing for a cost base increase should also be introduced as part of the proposed amendments to Division 6.

Allocating capital gains to unitholders

At the meeting on 16 March 2011 there was support from the professional bodies to adopt an alternative approach to the treatment of capital gains, based on codifying the positions set out in the Australian Taxation Office Practice Statement PS LA 2005/1 (GA).

The Property Council does not oppose the inclusion of principles based on the Practise Statement.

Start Date

The impact of adopting any changes to the term "the income of the trust estate" that apply from 1 July 2010 for the 2011 income year will need to be carefully considered.

The retrospective application means that trusts with substituted accounting periods have already completed that year's distributions. Similarly, some trusts have already made distributions and will have a comparable problem. This may mean that they will face penalty tax rates for any undistributed income.

We are keen to discuss the above points with you further at your convenience.

Please do not hesitate to contact Elaine Abery on (02) 9033 1929 or myself if you have any queries.

Yours sincerely

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Illustrative example

Two investors invest $150 each into a property unit trust (PUT). The investors are looking to pool their funds and use an external manager to secure an income stream and long term capital growth.

PUT buys two property assets, A for $100 and B for $200.

Annual distributions are made of the distributable income of PUT as determined by the manager – broadly net operating income (NOI) of PUT.

Property A increases in value to $150 and property B to $250 so each unitholder's investment is now worth $200 (versus a cost base of the units of $150).

Property A is sold for $150 and the proceeds are invested in property C which costs $150.

Under Division 6 as it currently applies, the investors are presently entitled to the distributable income of the trust (which excludes the CG) so each pays tax at their marginal tax rates on their proportionate share of the CG of $50 ($25 each) (ignoring discounting) even though they didn't receive a distribution of the capital gain.

Summary position

- investors cost base in the units is still $150 each (ignoring any CGT event E4 adjustments on income distributions) versus a value of the units of $200.
- Thus although the investors have paid tax on the capital gain they have received the economic benefit of the capital gain through an increase in the value of their units (note, under current law double taxation arises because there is no increase in their cost base in these circumstances – but would be under proposed MIT regime)
- It seems the proposed attribution rules under the MIT regimes would maintain the existing Division 6 position.
- PUT holds properties with a total value of $400 versus a cost base in the properties of $350.

Thus the value of the investments held by PUT has been maintained. This maintains the future income earning potential of PUT for its investors. If PUT was subject to tax on the capital gain retained the value of PUT's investments would be reduced resulting in less earning potential for the investors.