



General Manager
Business Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

10 February 2012

E-Mail: trust_rewrite@treasury.gov.au

Attention: Haydn Daw

Dear Haydn,

Modernising the Taxation of Trust Income - Options for Reform

Thank you for the opportunity to comment on reforming the taxation of trust income.

The Property Council is the peak body for owners and investors in Australia's \$400 billion property investment sector. The Property Council represents members across all four quadrants of property investment - debt, equity, public and private.

The industry welcomes Treasury's initiative to modernise the taxation of trust income by amending or rewriting Division 6. The Division will affect trust distributions and is critical for any property trusts that are not managed investment trusts (MITs).

The current Division 6 rules have been in place for a number of years and are understood by the industry. Clear, predictable and simple rules are vital to retain the international competitiveness of Australian property funds.

The industry needs:

- clear workable rules under both the MIT regime and Division 6;
- rules that reflect current industry practice;
- simple, clear rules on the interaction between the MIT regime and Division 6 rules;
- the MIT regime to be developed in conjunction with the new Division 6 rules; and
- the MIT consultation process to continue and for the outstanding issues to be workshopped.

The attached submission covers these issues. We are keen to discuss them 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

A handwritten signature in black ink, appearing to read 'AM', with a long horizontal flourish underneath.

Andrew Mihno
Executive Director International & Capital Markets
Property Council of Australia

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Modernising the Taxation of Trust Income

*Property Council of Australia
February, 2012*

PCA Division 6 Submission February 2012

PCA Division 6 Submission

Overview

- PCA focus is on completing the introduction of the remaining MIT rules.
- There is still uncertainty regarding important aspects of the MIT regime and we have yet to see the draft legislation.
- Division 6 is of vital interest as it remains relevant for trusts that do not qualify as MIT's.
- Therefore, PCA view is that Division 6 process must be closely aligned with the remaining MIT process.
- It is also important to consider how these rules will interact with other areas noted for amendment/introduction including the CIV rules and Division 6C,

PCA Division 6 Submission

The PCA wants to ensure that:

- there is clarity as to the definition of MIT;
- the majority of widely held property trusts (and their controlled entities) are safely within the MIT regime;
- the interaction between the MIT and Division 6 rules is clear;
- where Division 6 applies to a property trust, the methodology applied does not prevent the trust retaining capital gains and other income for reinvestment; and
- any common rules (eg expense allocation) apply appropriately in relation to all property trusts.

PCA Division 6 Submission

Division 6 General

- Division 6 will always be relevant because we accept that not all property trusts will necessarily be MIT's.
- The High Court decision in Bamford effectively validated the attribution position which the property industry had adopted for many years. Given that, the existing scheme of Division 6 remains largely relevant and appropriate to deal with property trusts.
- In fact, the remaining stage of the MIT-process is less attractive for many PCA members as proportional attribution is already the base case and via the MIT process comes at the cost of substantial new compliance based rules.
- It is to be hoped that the MIT rules which are stated to be a concession do not end up more limited than the base case Division 6 rules.

PCA Division 6 Submission

Division 6 General

- Where the proposed Division 6 rules apply, there is the potential for property trusts to be adversely affected because they will retain capital gains and other income for reinvestment and that is what attribution is designed to allow so clearly MIT is a preferred outcome for the property sector.
- Therefore border, overlap and MIT failure are all critical issues for the property industry.
- For example, it simply cannot be the case that significant listed MIT's such as GPT fall outside the MIT rules and into the rules designed primarily for discretionary trusts because of an overly restrictive approach to the definition of clearly defined rights

PCA Division 6 Submission

Proposed scope of revised Division 6

- From a PCA perspective we question the need for wholesale change.
- Each of the proposed approaches to change creates issues for property trusts. We have listed the key issues below.
- Any approach based on “following the money” presents issues for entities which retain capital gains and other income where it has already been accepted in a MIT context that property trusts must be allowed to retain, at least, capital gains if they are to have an ongoing business.
- The “preferred” trustee assessment and distribution model would appear to directly impact on these outcomes resulting in potential trustee tax on retained capital gains and the need to create significant new compliance models to deal with the subsequent distribution of these amounts many years in the future (assuming capital gains are retained for long periods).

PCA Division 6 Submission

Proposed scope of revised Division 6

- In effect any re-definition of distributable income (however it is formulated) creates issues for entities whose proportionate, undifferentiated distribution is based on the requirements of the market and general business needs rather than the exercise of individual discretions.
- For example, as already stated, a requirement to distribute taxable income would effectively force property trusts to distribute capital gains or the trustee would have to pay tax at 46.5%. Either outcome both reduces the monies available for re-investment and overturns well established and, up to now, uncontroversial tax outcomes in relation to property trusts.

PCA Division 6 Submission

Proposed scope of revised Division 6

- Further a change from the well established “proportionate” approach to a “quantum” method would equally change the distribution parameters of property trusts in a way similar to the “follow the money” approach
- As property trusts generally allocate income entitlements on the basis of a “books close” date. That is, those on the register at the end of the period are entitled to the income, the first part of present entitlement is not a significant issue.
- The second part of present entitlement being the need to establish the precise entitlement prior to year end is more problematic in a world where accounts need to be completed, capital gains determined etc...to expect that all to occur prior to year end is to say the least optimistic.

PCA Division 6 Submission

Proposed scope of revised Division 6

- There are aspects of the taxation of trusts that require change. For example, the position of bare trusts needs to be finally established. In our view, these trusts should be ignored for all tax purposes
- There are also aspects of the current analysis such as character flow-through which seem to be said to be issues where previously there had been no issue. The Court decisions on this aspect of the rules have been clear and uncontroversial for many years.
- Unfortunately, key problems with taxation of trusts like the issue of fixed trusts and the trust loss rules do not seem to be an immediate focus of the current process.

PCA Division 6 Submission

Summary

- From a PCA perspective the approaches proposed to Division 6 could have a material adverse impact on well established and essentially uncontroversial distribution practises.
- Any changes that give rise to uncertainty regarding the retention of capital gains and other income for commercial purposes have the potential to both impede the growth of the sector and adversely impact current market participants.
- We submit that the current tax processes and outcomes are insofar as they apply to non-discretionary trusts entirely appropriate and should not be adversely impacted upon by the proposed changes.

PCA Division 6 Submission

Our approach to Division 6:

- Interaction with the remaining MIT rules is critical. We need clear rules as to what is and is not a MIT and the consequences of failing to be MIT.
- First we want to maximise MIT coverage, ie the principle is that “MITs” should be covered by the MIT rules.
- Secondly, we need to deal with overlap issues, eg “MITs” which don’t have clearly defined rights or otherwise fail one of the MIT tests.
- Thirdly, we need to ensure that where Division 6 applies to a property trust the methodology applied is appropriate, ie the trustee is not subjected to top marginal rate tax on capital gains or other income retained for reinvestment
- Fourthly, we need to cover the development of common rules eg expenses allocation.

PCA Division 6 Submission

Maximising MIT coverage

- The first issue is to complete the work on the remaining MIT rules.
- We need clarity around critical concepts including most relevantly “clearly defined rights” so that we can access the extent of MIT coverage in the property sector.
- The scope of these rules needs to capture all trusts which the market regards as MIT’s – we simply cannot have a model which excludes listed property trusts from its scope because of their capital structure.
- The MIT definition should cover wholly-owned sub-trusts and JV’s.
- The definition of MIT used for Fund Payment withholding tax should be extended for the broader MIT regime.

PCA Division 6 Submission

Maximising MIT coverage

- Further, we need to consider the expansion of the definition of qualifying investors to expand the categories of MITs.
- We also need to look at other concepts within the existing rules. For example, we need to better define concepts like “investment management” to avoid unnecessary failures.

PCA Division 6 Submission

Dealing with overlap issues

- We then need to better understand the border and interaction rules between MIT and Div 6:
- For example, what happens if you are treated as a MIT over a number of income years and subsequently the ATO determines you were not a MIT.
- In most cases, tax will have been withheld over the years on advice to the trustee that the trust qualified as MIT with no ability to recover the money from the unitholders.
- There will be a plethora of combinations here but in the main the focus for the PCA will be on the consequences of falling out of MIT.

PCA Division 6 Submission

The development of common rules

- There is the potential for a number of rules to have common application.
- These include, expense allocation and the fixed trust concept.
- Obviously, the PCA has a vital interest in the development of such rules and a concern to ensure that integrity concerns in a Division 6 context do not result in rules which are unworkable in a MIT context.
- We have previously stated that we do not see the need for a trust which has “clearly defined rights” to satisfy a further fixed trust definition.
- In relation to expense allocation, we consider that the combination of the specific CGT rules and a general requirement for “reasonableness” are sufficient.

PCA Division 6 Submission

There are a range of other issues which require further development:

- Allocation of taxable income to beneficiaries – is allocation proportional to allocation of distributable income.
- If present entitlement remains relevant, what is the date by which present entitlement must be determined.
- Withholding of tax and reporting for distributions.
- Determining taxable income components and expense allocation.
- What is the appropriate alignment of the concepts of distributable income and taxable income to determine the amount to which a beneficiary is taxed on the taxable income of the trust.
- Whether trust amounts retain their character in the hand of the beneficiary.

PCA Division 6 Submission

Perhaps the critical starting point here is the choice of the new model.

Three options are noted:

- the “patch” model: effectively retain the current structure of Division 6 but reform the law by defining the term “income of the trust estate”.
- the “proportionate within class” model: this involves the distributable income of the trust being divided into different classes and the allocation of taxable income to those classes of income based on that allocation.
- the “trustee assessment and deduction” model: broadly, the taxable income of the trust is assessed in the hands of the beneficiaries that receive the economic benefits related to that taxable income with the trustee paying tax on any residual amounts.

PCA Division 6 Submission

PCA Comment

- The most important consideration for the PCA is that where Division 6 applies to a property trust, the methodology applied must not prevent the trustee retaining capital gains and other income for reinvestment by taxing the trustee on the retained income at the top marginal rate (or indeed as all).
- As we stated in the comments above, the distribution practises and outcomes in the property industry are driven by commercial requirements and have been supported by all judicial outcomes in relation to the relevant provisions.
- We see no need to disturb commercially driven and legally validated outcomes.

PCA Division 6 Submission

Interim Rules

- The next vital question from a PCA perspective is the question is what are the interim rules around things like the definition of fixed trusts and the appropriate time for the determination of the quantum of distribution entitlements.

PCA Division 6 Submission

We also need to discuss and understand the interaction of the development of these rules with other various other concepts including:

- Div 6C;
- CIV's; and
- top-hatting which is now effectively part of CIV's

As noted in our discussion, you might reasonably expect many MITs to become CIV's provided that is that the CIV rules offer a cost effective basis for a property trust to switch to a corporate flow through entity.

In effect, we would hope that MIT's are redefined to include corporate entities and limited partnerships within the classes of Australian vehicles which can be treated as MIT's.