Comment:

Reforming the Taxation of Trusts: Piecing Together the Mosaic

Graeme S Cooper*

Abstract

Until recently, the taxation of income held in trust was one of the few areas of Australian tax law left largely untouched by legislative tinkering. This comment recounts the history and current state of play of the many recent reform proposals that have been announced, and in some cases implemented, affecting the taxation of income subject to a trust. It then examines the range of competing causes which have coalesced around this issue. Because the influences are many, many projects have been initiated. The issues each project examines have often been framed by reference to size and market segment, rather than the trust as a form for organising relationships so that the same policy and design issues often appear in several projects but are not being solved in the same way. The possibility of coherent, coordinated and rational tax policy for taxing trust income emerging from these multiple, competing projects seems remote.

I Introduction: the Scale of any Reform to Trusts

Until relatively recently, the taxation of income subject to a trust was one of the few areas of Australian tax law untouched by the constant tinkering to which our legislators are prone. Those days have passed. The last six years have seen enormous turmoil in the systems for taxing trusts, propelled by multiple apparently unrelated causes. This comment recounts the history and current state of play of these reform proposals and then examines the disparate range of causes and concerns which have coalesced around trusts. This paper is about those projects: what they changed, why they happened and the problems they are creating for the future.

One of the distinctive features of the Australian economy is the amount of economic activity undertaken using trusts, rather than companies.[1] Trusts are not

---

* I am grateful for comments on earlier drafts by participants at the Australasian Tax Teachers Association Conference, the Federal Court-Law Council Conference and by reviewers of this paper.

1 The taxation statistics prepared by the Australian Taxation Office ('ATO') show more trusts now lodge tax returns each year than companies. In 2008–09, more than 1 million trusts lodged tax returns (663 392 trusts and 360 374 superannuation funds) compared to 762 442 companies. In 2009–10, this position continued with more trusts (702 078 trusts and 377 693 superannuation funds) than companies (777 207); ATO, 'Taxation Statistics 2008–09' (2011) 09' (Taxation Statistics, NAT 1001-03.2011, March 2011) 38, 55, 75 <http://www.ato.gov.au/content/downloads/cor00268761_2009TAXSTATS.pdf>; ATO, 'Taxation Statistics 2009–10' (Taxation Statistics, NAT 1001-04.2012, April 2012) 36, 54, 72 <http://www.ato.gov.au/content/downloads/cor00305922_2010TAXSTATS.pdf>. The figure for

restricted just to the private realm of deceased estates, charitable foundations and asset protection. In Australia, trusts often conduct the kinds of activities that in other countries might be restricted to entities operating in corporate or partnership form. The result is that any proposal to change the existing system of taxing income held in trust is momentous; certainly as significant as changes to the corporate tax regime.

In large part, using trusts is alluring because they have long been treated as transparent under Australian tax law so that the tax liability on income derived through a trust arises only once, usually in the hands of the investor or beneficiary. For non-resident investors, the transparency paradigm had the distinct advantage that foreign source income could pass through an Australian resident trust without triggering an Australian tax liability.[2] It also meant that Australian source income could pass through an Australian resident trust without losing its original character: if a trust earns interest income, it remains interest income when distributed, unlike amounts flowing through a company which would often emerge as a dividend.[3] A non-resident, therefore, does not suffer a different tax outcome whether it invests directly into a project or indirectly through a resident trust.

While there are few commercial or regulatory restrictions on using a trust to conduct commercial activities, there are tax rules dating back to the mid-1980s which discourage publicly held trusts from conduct trading and industrial activities.[4] These activity limitation rules, which are intended to protect the corporate tax base from erosion, are intended to limit the use of widely held trusts to passive operations: investing in land or in certain kinds of financial instruments. Hence, a small group of (non-trust) investors who use a trust to operate a railway or mine can retain tax treatment as a trust, but if the trust is to be marketed to a broad range of investors, the trust is subjected to tax as if it is a company and some of the tax advantages will disappear.[5] For this reason, Australian trusts which are marketed to retail investors invariably limit their operations to investing in land or dealing in securities.

It was noted above that trusts are pervasive, but one can differentiate several key areas in commerce where trusts are especially significant.

First, retail collective investment in Australia is invariably conducted through trusts. These trusts (usually called 'managed investment schemes'

---

companies also includes corporate limited partnerships and the few trusts subject to the *Income Tax Assessment Act 1936* (Cth) pt III div 6C ('*ITAA 1936*').

2 This was not possible for income passing through resident companies until 1994 and the enactment of the first set of rules giving effect to the conduit income paradigm. See *Taxation Laws Amendment Act (No 3) 1994* (Cth).

3 This proposition, which was once regarded as uncontroversial, has, according to the ATO, now been thrown into doubt by the High Court decision in *Commissioner of Taxation v Bamford* (2010) 240 CLR 481 ('*Bamford*'). See ATO, *Decision Impact Statement – Commissioner of Taxation v Bamford* (2 June 2010) <http://law.ato.gov.au/atolaw/view.htm?locid='LIT/ICD/S310/2009'&PiT=20100602000001>. The merits of this position are discussed in more detail in part 4 below.

4 *ITAA 1936* pt III div 6B (income of public unit trusts), pt III div 6C (income of public trading trusts).

5 The limitation to non-trust investors is significant. While the closely held special purpose trust may escape the effect of these rules, an investor which was also a trust, but a widely held unit trust, could find its own status affected if it invested in another trust which breached the activity restrictions.

('MIS')) are highly regulated under Australian investor protection law.[6] They will offer interests to the public and are typically differentiated commercially on the basis that the fund is invested in identified asset classes — Australian shares, Australian bonds, foreign equities, commercial property, a diversified pool of assets, and so on. These funds will usually have a mix of resident and non-resident retail investors, and hold assets in Australia and abroad.[7]

These retail collective investment vehicles will often hold their assets indirectly, by investing in other trusts (usually called 'wholesale funds') which will hold the shares, bonds, property and so on. In fact, there will often be several layers of trusts between the retail trust and the entity holding the assets. These funds will usually have a mix of resident and non-resident institutional investors.

Looking beyond funds management, trusts are common in the broader economy. Many of the largest commercial entities listed on the Australian stock exchange, particularly in the property sector, are trusts in form or else a company and trust 'stapled' together. For commercial groups that are nominally headed by a listed company, it is usually the case that a large number of trusts will be included in the consolidated group. This is because trusts are often used as special purpose vehicles by large commercial enterprises wishing to undertake sizeable joint operations. This is common in the commercial property sector where several institutions — for example, a property developer, a financier and several pension funds — might decide to undertake a real estate development using a resident trust as the coordinating entity.

Private trusts are a standard form used in commercial activities by the small and medium-sized business segment. In fact, three-quarters of all trusts that lodge with the ATO are discretionary trusts.[8] Small trusts do not face the problems of being potentially taxed as companies: discretionary trusts and closely held fixed trusts will almost never qualify to be a public unit trust[9] or a public trading trust.[10] Most small businesses will be operated by, or will involve investment in or from, the trustee of a trust of some kind.

Finally, express trusts continue to operate in their traditional private realm: established for asset protection; set up under wills; operating charitable foundations and community activities; and as means of organising orderly succession planning.

The point is simple but crucial: the trust form is prevalent and manifests itself in different ways and to differing effect in the large business segment, the

---

6 The legal architecture for regulating managed investment schemes is found in *Corporations Act 2001* (Cth) ch 5C. The administrative oversight lies with the Australian Securities and Investment Commission ('ASIC').

7 The development of the managed funds industry in Australia and the early tax rules applicable to them is discussed in Paul Dowd, 'Contemporary Tax Issues for Managed Funds' (2008) 12 *Tax Specialist* 99. As Dowd notes, 'Listed Investment Companies, another commercial form for funds management operations, also operate in the industry but their size and significance is much smaller': at 99.

8 ATO, above n 1, 76, table 6.1.

9 *ITAA 1936* s 102G.

10 Ibid s 102P.

small business environment and the family/household sector. Consequently, changes to the system of taxing income derived through trusts affect very many different taxpaying constituencies, each with their own concerns. To foreshadow what is to come, it also explains why so many players are seeking reform and why their interests often diverge.

II The Pieces of the Mosaic

This comment examines the complexity caused by the recent, multiple, poorly-coordinated trust reform projects.[11] Before examining their causes and potential effects, it is useful to order and distil the various projects that have been implemented during the last six years.

At least six different reform projects can be isolated. The first is the project to rewrite the rules for taxing the income of resident investors with interests in foreign trusts, announced in October 2006 and still continuing.[12] This project addresses outbound investment and the circumstances where resident taxpayers will be taxed on the undistributed income (or some proxy for that amount) of non-resident trusts. It led to the repeal of some of the rules for foreign trusts and the specific Foreign Investment Fund ('FIF') rules,[13] but the replacement Foreign Accumulation Fund ('FAF') rules have not emerged in final form.

The second project, the managed investment trust ('MIT') proposals, is a multi-faceted undertaking. It has been in contemplation since May 2006 and is still continuing.[14] This project has involved both the reform of existing rules and the creation of a new paradigm for taxing income earned through an entity that came to be labelled a MIT. Some milestones already accomplished during the life of this project include changes to the rate and method of taxing non-residents investing in MITs, changes to the characterisation of amounts earned by MITs, changes to allow restructuring and new MIT structures to operate, changes to the scope of the activities from which MITs are effectively excluded, and the promised repeal of other activity restrictions.[15] But the most significant part of this project is still to be

---

11 Because this paper is about the projects which have been taken up by the government, I am not going to look at some of the work that is, at this stage, being driven solely by the ATO, such as the work on resettlements, the meaning of 'absolutely entitled' or the current campaign to ensure trustees document (as well as make) their resolutions by 30 June. This paper is not about Treasury's recent project to explore an 'entity flow-through regime' for small business. This idea is referred to in ATO, *Commissioner's Small Business Consultative Group Minutes 24 May 2012 3 Small Business Tax Administration* <http://www.ato.gov.au/businesses/content.aspx?menuid=0&doc=/content/00325494.htm&page=5&H5>. It is apparently seen as a means of reducing the compliance requirements for small business.

12 Peter Costello, Treasurer, 'Board of Taxation Reviews' (Press Release, No 109/2006, 10 October 2006) <http://www.treasurer.gov.au/DisplayDocs.aspx?pageID=&doc=pressreleases/2006/109.htm&min=phc>.

13 *Tax Laws Amendment (Foreign Source Income Deferral) Act (No 1) 2010* (Cth).

14 Peter Costello, Treasurer, 'Further Measures to Simplify and Streamline the Tax System' (Press Release, No 39/2006, 9 May 2006) <http://www.treasurer.gov.au/DisplayDocs.aspx?pageID=&doc=pressreleases/2006/039.htm&min=phc>.

15 The Assistant Treasurer announced in May 2010 that *ITAA 1936* div 6B would be repealed. Nick Sherry, Assistant Treasurer, 'New Tax System for Managed Investment Trusts' (Press Release, No 86/2010, 7 May 2010) <http://assistant.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/

accomplished: the MIT project will eventually lead to a parallel tax regime for resident investors in MITs. Their tax liability will be governed by a so-called 'attribution' regime in lieu of the current rules.[16] The attribution regime, which was scheduled to start on 1 July 2011,[17] then 1 July 2012,[18] and then 1 July 2013,[19] will not commence until 1 July 2014.[20]

The next project, the investment manager regime ('IMR'), was under consideration since 2008, formally announced on 11 May 2010 and is still ongoing.[21] Again, this project combines several distinct elements, all intended to eliminate Australian tax for non-residents. The second element of the IMR project is intended to eliminate any Australian tax liability where non-resident investors use the services of resident fund managers which might potentially create a 'permanent establishment' in Australia.[22] The first element deals with the consequences of that problem for past years.[23] The third part of the IMR package is directed to the situation of foreign funds with foreign management.[24] It is intended to eliminate for foreign collective investment vehicles any Australian tax on Australian source revenue gains made from dealings with portfolio interests in Australian companies and with financial arrangements.

2010/086.htm&pageID=003&min=njsa&Year=&DocType>. No legislation has yet been enacted to give effect to this announcement.

16 *ITAA 1936* pt III div 6.

17 Sherry, above n 15.

18 Bill Shorten, Minister for Financial Services and Superannuation, 'Start Date of the New Tax System for Managed Investment Trusts' (Press Release, No 50/2011, 8 April 2011) <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2011/050.htm&pageID=003&min=brs&Year=&DocType>.

19 Wayne Swan, Treasurer, 'Tax Measures in Mid-Year Economic and Fiscal Outlook' (Press Release, No 148/2011, 29 November 2011) <http://www.treasurer.gov.au/wmsDisplayDocs.aspx?doc=pressreleases/2011/148.htm&pageID=003&min=wms&Year=2011&DocType=0>.

20 David Bradbury, Assistant Treasurer, 'Gillard Government Progresses Trust Reforms' (Press Release, No 80/2012, 30 July 2012) <http://assistant.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2012/080.htm&pageID=003&min=djba&Year=&DocType=>.

21 Chris Bowen, Minister for Financial Services, Superannuation and Corporate Law, 'Australian Government Commences Consultation on an Investment Manager Regime' (Press Release, No 46/2010, 11 May 2010) <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2010/046.htm&pageID=003&min=ceba&Year=&DocType=?>.

22 Legislation to give effect to the first two parts of the IMR package was introduced into Parliament on 21 June 2012 and was passed by the Senate in August 2012: See *Tax Laws Amendment (Investment Manager Regime) Act 2012* (Cth). No legislation has yet been released to give effect to the third part of the IMR package.

23 It is essentially intended to assure a largely United States ('US') audience that US-resident investors who used the services of Australian fund managers do not have an Australian tax exposure for the 2010–11 income year and prior years. The concern is that foreign investment funds may have had an unrecognised exposure to Australian tax which enthusiastic auditors, particularly in the US, would require to be recognised in the accounts of the fund. The proposed changes to Australian tax are intended to remove that exposure retrospectively. This is typically referred to as the 'FIN 48' measure.

24 Assistant Treasurer, 'Government Announces Final Element of Investment Manager Regime' (Press Release, No 168/2011, 16 December 2011) <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2011/168.htm&pageID=003&min=brs&Year=&DocType>.

A fourth project is the review of collective investment vehicles ('CIVs') announced in 11 May 2010 and still ongoing.[25] This project appears to be a more ambitious version of the MIT project, although the articulation between this project and the MIT project is less than clear. The object of this project is to examine 'whether a broader range of tax flow-through vehicles should be permitted',[26] which suggests that the focus is more about reconsidering the range of entities eligible to have transparency treatment than it is about the design of income allocation methods in a transparency model.[27]

The next project involves redrafting the trust income regime in the *ITAA 1936* (Cth) div 6 — the central set of rules for taxing income subject to a trust. It was announced on 16 December 2010,[28] was due to be concluded and operational by 1 July 2013, but will now not start before 1 July 2014.[29] Like the MIT and IMR projects, the redrafting project generated its own collection of sub-projects. The first was the dividend and capital gain 'streaming' measures, announced on 4 March 2011 and finalised in June 2011.[30] They were apparently intended only as a temporary measure and slated for replacement in 2012, but the repeal of these rules has now been deferred until 1 July 2014, when they will be superseded by the new div 6.[31] The second element is the aborted 'net income' proposal announced in 4 March 2011 and dissolved in April 2011.[32] The third sub-project involved two

---

25 Bowen, above n 21. See also Board of Taxation, 'Review of the Tax Arrangements Applying to Collective Investment Vehicles' (Discussion Paper, Board of Taxation, 17 December 2010). It is understood that the Board's final report has been sent to the Assistant Treasurer's office, but neither the report nor the government's response has yet been made public.

26 Board of Taxation, above n 25. This project also had a specific task of examining the appropriateness of Australia's Venture Capital Limited Partnership regime.

27 It is striking to note the difference a decade makes. In 1999 the Review of Business Taxation proposed a considered and comprehensive statutory regime for taxing the income of collective investment vehicles formed as trusts. Review of Business Taxation, *A Tax System Redesigned: More Certain, Equitable and Durable* (Treasury, 1999) ch 16. The proposal was ignored. Ten years later, at least three projects are examining onshore and offshore collective investment vehicles and their investors.

28 Bill Shorten, Assistant Treasurer, 'Farmers Benefit with Changes to Trust Laws' (Press Release, No 25/2010, 16 December 2010) <http://mfss.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2010/025.htm&pageID=003&min=brsa&Year=2010&DocType=0>.

29 Bradbury, above n 20.

30 Bill Shorten, Assistant Treasurer, 'Providing Certainty for Trusts' (Press Release, No 40/2011, 4 March 2011) <http://mfss.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2011/040.htm&pageID=003&min=brsa&Year=2011&DocType=0>. This measure was announced by the government in light of problems said to arise from the High Court's decision in *Bamford*. It led to substantial amendments to the structure and operation of *ITAA 1936* div 6 (taxation of trusts), *Income Tax Assessment Act 1997* (Cth) ('*ITAA 1997*') div 115 (discount for capital gains) and ITAA 1997 div 207 (franking). The operation of these provisions is described in detail in Ken Schurgott, 'Trust Streaming' (2011) 46 *Taxation in Australia* 18. Their background in the *Bamford* and *Colonial First State* litigation is examined in Chris Colley, 'Testing the Limits of Trust Flexibility after *Bamford*: The *Colonial First State* Decision' (2011) 14 *Tax Specialist* 201.

31 The streaming measures were apparently to be replaced as part of the rewriting project (Project 5 : see below n 32). See Explanatory Memorandum, Tax Laws Amendment (2011 Measures No 5) Bill, [2.11], describing the measures being proposed as 'an interim measure pending the broader review of the taxation of trust income.' See also Ken Schurgott, 'Taxation of Trusts — Are we There Yet?' (Paper presented at 44th Western Australian State Convention of The Taxation Institute, Bunker Bay WA, 11 August 2011) 204.

32 This proposal is perhaps best understood as a misstep along the road to the redrafting project which had been announced four months earlier. This separate 'net income' proposal was abandoned and rolled into the broader 'modernisation' project (Project 5) in April 2011. See Bill Shorten, Assistant

interim measures 'to target the use of low tax entities, especially exempt entities, to reduce the tax payable on the taxable income of a trust',[33] and was the substitute for the failed 'net income' proposal. These measures were enacted in June 2011, but the key part of this project, the redrafting of div 6, remains incomplete.

The last project involves rewriting the 'fixed trust' rules. It was foreshadowed on 21 November 2011 and is still ongoing.[34] This project is apparently intended to resolve the difficulty that the current drafting creates in a number of situations, particularly with respect to the ability of many trusts to use carry forward revenue losses and deduct bad debts written off.[35]

Presenting a list in this manner implies that the projects are relatively discrete. That is not the case. Several of these projects combine and overlap. Indeed, the articulation between these disparate projects is mysterious. Some appear to be duplications, some appear to supersede others, some are clearly temporary, some are false starts and some just stand-alone housekeeping.

It is remarkable that, despite the enormity of the changes already made and those in train, very little has been written about them and much remains to be analysed. The projects appear to address trusts operating in different market segments, rather than approaching trusts simply as one form for organising commercial activity. Several of them appear to address the same segment of the market and yet no explicit interaction between them has been recognised. This means that the same policy and design issues appear in multiple projects, but are rarely being solved in the same way.

Being divided on size and market lines means that the projects display duplication and a lack of coordination. For example, character retention questions that have now appeared in the div 6 rewrite project were already apparent in 2008 in the MIT and CIV projects. The streaming measures, enacted in mid-2011 and driven by concerns about the impact of the *Bamford* case,[36] address issues that were also apparent in the *Colonial First State* litigation, which involved widely

Treasurer, 'Improving the Taxation of Trust Income' (Press Release, No 52/2011, 13 April 2011) <http://mfss.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2011/052.htm&pageID=003&min=brsa&Year=2011&DocType=0>: 'the Government will defer consideration of the proposal to better align the concept of "income of the trust estate" with "net income of the trust estate" to the broader update and rewrite of Division 6.'

[33] Shorten, above n 32.

[34] Bill Shorten, Assistant Treasurer, 'Over 660,000 Trusts to Benefit from Tax Reforms' (Press Release, No 155/2011, 21 November 2011) <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2011/155.htm&pageID=003&min=brsa&Year=&DocType=0>. See also Treasury, 'Modernising the Taxation of Trust Income — Options for Reform' (Consultation Paper, Treasury, November 2011) <http://www.treasury.gov.au/~/media/Treasury/Consultations%20and%20Reviews/2011/modernising%20trust%20income%20tax/Key%20Documents/PDF/Consultation_Paper_Modernising_Taxation.ashx>. The private sector and the ATO identified a number of other areas of the tax law that would benefit from being updated and rewritten, including the fixed trust, trust loss and family trust rules contained in *ITAA 1936* sch 2F. The current issues with the legislative definition of 'fixed trust' will be examined through a separate process.

[35] Bradbury, above n 20. See also Treasury, 'A More Workable Approach for Fixed Trusts' (Discussion Paper, July 2012) <http://www.treasury.gov.au/~/media/Treasury/Consultations%20and%20Reviews/2012/A%20more%20workable%20approach%20for%20fixed%20trusts/Key%20documents/PDF/fixed_trusts.ashx>.

[36] *Bamford* (2010) 240 CLR 481.

held investment trusts.[37] Finally, debates about optimal ways of allocating the liability to pay tax on taxable income between various groups of beneficiaries, currently being fought in relation to the div 6 rewrite, have already been fought and resolved in relation to managed funds in the MIT project.

While it might be expected that there would always be some more or less subtle variations between the tax regime for privately held and the rules for publicly traded entities, be they companies or trusts,[38] these projects show much more marked and uncoordinated disparities developing within the world of trusts.[39]

III Drivers of Trust Reforms

Trust tax has been a relatively sleepy backwater of tax law for almost 60 years, so what has impelled so much and such radical change in just a few years? The causes of these projects are many, but I will isolate five: a conscious decision by the ATO to propose and then test by litigation some new — and as it turned out, unsustainable — theories about the operation of the trust provisions, the politics of election campaigns and the incentives for political parties to outbid rivals for key constituencies, industry pressure to push back borders, reduce constraints, expand the range of customers and increase market size, governments' irresistible desire to pick winners and support their industry policies through the tax system and, finally, changes to the formerly dominant theories about sound international tax policy.

I am not suggesting that these causes are discrete, that there are no feedback effects between them or that they manifest themselves in just one of the reform packages listed above. On the other hand, they offer a plausible explanation why there is so much activity and why the projects reflect such different concerns; there are multiple players each seeking their own ends.

A *ATO Initiative*

The first cause proposed above was the ATO's decision to test the trust measures. It has done this by making a series of public pronouncements and then embarking on a course of speculative litigation. This was a considered course of action, driven by concerns about the way that the system for taxing income derived through trusts operates, especially perceived abuses in the context of private or closely held

---

37 *Colonial First State* [2011] FCA 16.

38 The obvious examples are *ITAA 1936* div 7A, which applies only to dividends paid by private companies, and *ITAA 1936* divs 6B and 6C, which apply only to activities conducted by publicly held trusts. Differences like these are more common in the system for taxing companies where the legislation differentiates between privately held and publicly traded entities with respect to the ability to carry forward losses, the pre-capital gains tax ('CGT') status of corporate assets, the strictures surrounding franking benchmarks, and so on.

39 It is also worth noting that in regard to several of these projects, policy decisions are often driven by a demarcation whether people are taking portfolio or non-portfolio positions in underlying activities. The emergence of portfolio or non-portfolio interests has proved very important to parts of the MIT and CIV projects.

trusts.[40] In order to understand the ATO's concerns it is necessary to set out the elements of the system in a little detail.

1 *The Starting Position*

In the simplest and most common case — an express trust set up *inter vivos* — the rules in *ITAA 1936* div 6 allocate the tax liability on income held in trust by requiring every beneficiary who is 'presently entitled' to a share of the 'income' of the trust to include in their own assessable income a commensurate share of the 'net income' (the term confusingly used to denote taxable income) of the trust. It is essentially an allocation procedure, using the entitlement to enjoy 'income' as the metric for allocating the tax debt in each year between the entities that might have been selected to pay the tax: the various beneficiaries and trustee.

Until the ATO's challenge, it had generally been understood that the amount used as the metric — the 'income' of a trust — was not an externally dictated and immutable concept. It derived instead from trust law, and the trust law meaning is the one employed for tax purposes. This is not a case where tax law begins from a trust concept but then modifies that trust law meaning for tax purposes. This meant that the 'income of the trust estate' is a contingent notion which will differ for each trust by virtue of either provisions in the trust deed which define the 'income' of that trust, or the proper exercise of powers conferred on the trustee by provisions in the trust deed permitting it to determine which amounts form the 'income' of the trust, or both. However, it was also appreciated that using this metric has the consequence, for trusts with different income and capital beneficiaries, that the people entitled to 'income' must pay tax on the capital gains made on realising trust assets, even though, as a matter of trust law, they will not enjoy the benefit of those gains. The ATO had attempted to solve this problem by administrative fiat in several practice statements.[41]

It was also accepted that the 'share' being referred to is a proportion of that distributable amount, rather than an absolute figure. This position had been questioned in two Federal Court decisions but the matter was regarded as resolved in favour of the view that 'share' meant a proportion of distributable income.[42]

---

[40] It is widely suspected that the Australian Treasury and the ATO would much prefer a system for taxing trusts that mirrored as closely as possible the system for taxing corporations and shareholders. Such a system was a fundamental recommendation of the 1999 *Review of Business Taxation* (above n 27) at 261 ('the general principle is that trusts will be subject to the entity tax regime'). After two years' work, the proposal was officially abandoned by the Howard Government in 2002. Treasurer, 'Entity Taxation' (Press Release, No 8/2001, 27 February 2001) <http://www.treasurer.gov.au/DisplayDocs.aspx?pageID=&doc=pressreleases/2001/008.htm&min=ph c>. The lesson of Australia's recent tax history is that reform proposals rarely die, although they sometimes hibernate, but for the moment, the political landscape is such that the merest suggestion of 'taxing trusts like companies' spells doom for any politician who dares to ponder aloud. See, for example, Peter Martin, 'Hockey in Doghouse over Trusts,' *The Age* (Melbourne), 8 April 2011; Sid Maher, 'Joe Hockey Trusts Plan "Irresponsible"' *The Australian* (Sydney), 7 April 2011.

[41] Practice Statement (General Administration), PSLA 2004/3, 18 June 2004; Practice Statement (General Administration), PSLA 2005/1, 1 September 2005 (withdrawn: 13 October 2010).

[42] *Zeta Force Pty Ltd v Commissioner of Taxation* (1998) 84 FCR 70, 83: 'the weight of authority thus supports the opinion I have expressed … that the proportionate method is that contemplated by s 97'; *Richardson v Commissioner of Taxation* (1997) 80 FCR 58, 58:

Because a trust is simply an arrangement between people about how various amounts will be dealt with, the fact of the trust does not change the underlying source or character of amounts when examined in the hands of beneficiaries. So, for trusts which provide that one type of amount will be dealt with differently from another type of amount, the tax consequences for the beneficiaries follow.

If the question were asked in a vacuum — how should the liability be allocated for paying tax on income that is subject to a trust? — it is easy to conceive of other metrics that might have been used: the rules might have allocated the tax liability based on interests in attributes other than income; for example, interests in the corpus of the trust, perhaps using the number of units held for unit trusts with undifferentiated units. It might have allocated the tax liability using the proportions of amounts actually received in the current year, rather than amounts which the beneficiaries were entitled to receive. It might have allocated to the beneficiaries the tax liability on amounts actually received and to the trustee the tax liability on undistributed amounts. While there are undoubtedly other possibilities, the system that actually operated was relatively well understood and seemed for the most part to be stable and effective.

2 *The Evolving ATO Challenge*

It is against this background that the ATO began its campaign to test the prevailing wisdom. A number of common arguments challenging the accepted wisdom develop in the flurry of activity described next. The most insistent arguments put by the ATO revolved around aspects of the meaning of the word 'income' when used in *ITAA 1936* div 6: that the word 'income' means just income according to ordinary concepts and usages and does not, for example, include amounts which represent gains of a capital nature. This would mean, for tax purposes, that the word 'income' could not be modified either by the effect of specific provisions of the deed or by the exercise of trustee powers conferred in the deed to classify amounts as 'income'.

While the undertone of ATO disquiet with the taxation of trusts is not new, this concern became more visible from 2008. In a speech delivered in March 2008, a Second Commissioner of Taxation spoke at length about areas of trust taxation the ATO saw as troubling.[43] In particular, he went to some pains to try to demonstrate how *Cajkusic v Commissioner of Taxation*,[44] a case the ATO lost,

---

when trust income exceeds the trust's taxable income a proportionate approach is adopted to determining the distribution of assessable income to beneficiaries presently entitled under s 97(1). But, when the trust's taxable income exceeds the trust income a quantum approach is to be adopted to determine the distribution of assessable income in relation to the beneficiary presently entitled to the trust income under s 97(1). In the latter case the deficiency will be undistributed "income" to which no beneficiary is presently entitled and will be taxable income of the trustee under s 99 or s 99A of the Act'.

[43] Bruce Quigley, 'Trust Matters', (Speech delivered to the National Convention of the Taxation Institute of Australia, Adelaide, 13 March 2008) <http://www.ato.gov.au/corporate/content.asp?doc=/content/00128126.htm>.

[44] (2006) 155 FCR 430 ('*Cajkusic*').

could be interpreted in a way that was consistent with the ATO's preferred view about how the taxation of trusts worked. He foreshadowed as follows:

> We have indicated that we will seek to further test the trust income issue in the appellate courts as soon as the opportunity arises. We have also indicated that we do not propose to conduct active compliance activities targeted at this issue. However if the issue arises in an audit, or if the ATO is asked to rule on a specific case in the context of a private or class ruling, then we will have no alternative but to apply the law as we understand it to operate.[45]

He also defended the Decision Impact Statement issued by the ATO in November 2007,[46] in which the ATO had explained its understanding of the implications of the *Cajkusic* decision, trying to limit its impact.[47] The Statement had contained text such as, 'the Commissioner does not understand the case to be authority for the proposition that …' and 'the Commissioner considers he must continue to follow what he understands to be the reasoning of the High Court'. Importantly, it also contained the promise that, 'in view of some uncertainty about this issue the Commissioner will seek to further test the issue in the court as soon as the opportunity arises'.[48]

In the meantime, the ATO released a discussion paper titled, 'Trust Income, Share, Distributable Income and Related Matters' to a selected audience apparently in June 2008.[49] It contained a general assertion that the law about the taxation of income derived through trusts is in a state of disarray:

> The Tax Office does not consider that any of the meaning of 'income of the trust estate' in subsection 97(1), the meaning of 'share' in that provision, the relevance of, and measurement of, distributable net income of the trust in determining present entitlement of beneficiaries is settled law.

While the ATO may have held such a view, it is hard to see what basis for it existed at the time.

Also in 2008, the ATO released to a select group a draft practice statement on the 'Taxation of the Section 95 Net Income of a Trust.' The document was circulated for comment at a National Tax Liaison Group ('NTLG') meeting. The document set out the ATO's ideas and interpretations about how the trust regime should work. These interpretations were generally viewed by the profession as contrary to the long-held understandings about how div 6 works. That document

---

[45] Quigley, above n 43.

[46] ATO, *Decision Impact Statement, Cajkusic and Ors v Commissioner of Taxation* 17 September 2005 <http://law.ato.gov.au/atolaw/view.htm?DocID=LIT/ICD/VID279of2006/00001>.

[47] Quigley, above n 43.

[48] ATO, above n 46.

[49] The document does not appear to have been released publicly by either the ATO or Treasury, although its existence is evident in various places such as the responses to it evident, for example, in an email from Heather Schache, General Manager Taxation and Superannuation Publications, Taxpayers Australia to Kate Roff, Chair, NTLG, 9 October 2008 <http://www.taxpayer.com.au/downloads/Trust_submission.pdf> and an email from Peter Verwer, Chief Executive, Property Council of Australia to Lyn Freshwater, Secretariat — Trust Consultation Sub Group ATO, 1 October 2008 <http://www.propertyoz.com.au/library/Div_6_Submission_1_Oct_2008.pdf>. Its content was apparently discussed at the Taxation of Trusts — Consultative Roundtable held in Sydney on 30 September 2008.

was revised and a further draft circulated in December 2008.[50] After some disquiet in several consultation forums about what the revised document proposed, it was withdrawn in mid-2009.

The ATO focused attention on the litigation in *Bamford*, which was running at that time, apparently in fulfilment of the promise to test the ATO's position in court. That exercise did not prove an unqualified success for the ATO. Its new interpretations of 'income' were rejected by the Administrative Appeals Tribunal,[51] the Full Federal Court[52] and the High Court.[53]

After the ATO's loss in the Full Federal Court in June 2009, a modified version of the disputed Practice Statements reappeared in August 2009. The ATO formally released Practice Statement PSLA 2009/7 which, on one reading, directed ATO staff to ignore the Full Federal Court judgment and continue to administer the disputed interpretations, until the High Court ruled otherwise, at least in cases that the ATO identified as abusive.[54]

The High Court's judgment in *Bamford* was short, clear and entirely unremarkable. It rejected the ATO's argument about the meaning of 'income of the trust estate' in seven paragraphs[55] and dispensed with the taxpayer's argument about 'share' in just four paragraphs.[56] The judgment was straightforward and consistent with the profession's understanding of the rules.

3 *The Post-*Bamford *Strategy*

It is a plausible view of this history that the events from 2008 show an activist ATO trying out some novel arguments before the courts, arguments that were found unsuccessful.[57] The arguments that had been posited before the High Court in *Bamford* ('income' means just income according to ordinary concepts and usages and cannot be modified either by the deed or trustee action) failed. One obvious resolution of these events would have been for the ATO to accept that outcome and revert to the accepted wisdom.

---

[50] This history is recounted in ATO, NTLG Minutes, March 2009 – *16. Trust Practice Statement* (3 May 2010) <http://www.ato.gov.au/taxprofessionals/content.aspx?menuid=0&doc=/Content/00194162.htm&page=18>.

[51] *Bamford and Commissioner of Taxation* (2008) 70 ATR 199.

[52] *Bamford v Commissioner of Taxation* (2009) 176 FCR 250.

[53] *Bamford* (2010) 240 CLR 481. See generally Anthony Slater, 'Taxing Trust Income after *Bamford's* Case' (2011) 40 *Australian Tax Review* 69.

[54] Practice Statement PSLA 2009/7, 20 August 2009 (withdrawn 2 June 2010) [4]–[5]: 'pending a determination by the High Court in *Bamford* on the appeals, staff are to observe the following directions when dealing with trust issues arising under Division 6 of Part III (Division 6). Staff should continue to undertake compliance work involving trusts in the specific circumstances outlined in this Practice Statement [and] any assessment that issues as a result of this work should be based on the Commissioner's view of 'income of a trust estate' and 'share'.

[55] *Bamford* (2010) 240 CLR 481, 505–6 [36]–[42].

[56] Ibid 507–8 [43]–[46].

[57] See Teresa Dyson and Sarah Hickey, 'Trusts, Tax and the Turbulent Path Towards Reform (Part 1)' (2010) 13 *Tax Specialist* 254; Teresa Dyson and Sarah Hickey, 'Trusts, Tax and the Turbulent Path Towards Reform (Part 2)' (2010) 14 *Tax Specialist* 34.

Instead, the ATO turned its attention to the legislators. The result of *Bamford* had to appear to be more than the courts simply rejecting an unorthodox argument, so it was represented in two slightly different ways: as exposing existing deep problems in div 6; and as introducing fresh problems that had not existed before. Both circumstances buttressed the argument for specific remedial legislative action.

The evidence of a campaign to convey this impression of old and new disarray can be seen in several places. The High Court's judgment in *Bamford* was delivered in March 2010. In June 2010 the ATO issued new Practice Statement, PSLA 2010/1, which regarded *Bamford* as not settling the law. Instead, there was: 'ongoing uncertainty about the meaning of the expression "income of the trust estate" as used in Division 6 (and, in particular, in section 97)'.[58] A decision impact statement was issued at the same time, which said it was now necessary to withdraw a number of rulings which were impugned by the High Court's decision.

Not only did *Bamford* not settle anything, but by the time the Assistant Treasurer announced the review of div 6 in December 2010, the press release treated *Bamford* as laying bare old problems:

> The recent High Court decision in *Commissioner of Taxation v Bamford* highlighted ongoing discrepancies between the treatment of trust income by trust laws, on the one hand, and by the tax system on the other. Tax outcomes for beneficiaries of trusts often do not match the amounts they are entitled to under trust law and the trust deed. This can result in unfair outcomes as well as opportunities for taxpayers to manipulate their tax liabilities.[59]

The Assistant Treasurer's speech on 4 March 2011 continued the theme referring to 'two key areas of uncertainty for trusts following the High Court's *Bamford* decision.'[60]

Establishing exactly what these two problems are turned out to be rather elusive.

Problem No 1. The two areas were apparently identified in a report provided by the Board of Taxation ('the Board') that has not been made public. According to the Assistant Treasurer, the first amendment was needed: '[to] clarify the definition of the income of a trust estate. This will address situations where the tax burden falls on a beneficiary despite not receiving the economic benefit.'[61]

But the Press Release which accompanied the speech put the matter somewhat differently, saying that the object of the first part of the project was 'better [to] align the concept of "income of the trust estate" with "net income of the trust estate."'[62]

---

[58] Practice Statement PSLA 2010/1, 2 June 2010 [6].

[59] Shorten, above n 28.

[60] Bill Shorten, Assistant Treasurer, 'Taxation Institute of Australia 26th National Convention' (Speech delivered at the Taxation Institute of Australia 26th National Convention, Brisbane, 4 March 2011) <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=speeches/2011/007.htm&pageID=005&min=brs&Year=&DocType=>.

[61] Ibid.

[62] Shorten, above n 30.

The second description seemed more apt, judging from the consultation paper released at the same time.[63] But the Explanatory Memorandum to the June Bill reverted to the first idea and continued this assertion that it was *Bamford* which had revealed a deep underlying fault:

> 2.7 This decision has highlighted a number of longstanding problems with the taxation of trusts. In particular, it has highlighted that the amounts on which a beneficiary is assessed do not always match the amounts that they are entitled to under trust law. This mismatch can result in unfair outcomes, as well as opportunities for tax manipulation.[64]

The claim of 'ongoing uncertainty' about the meaning of the expression 'income of the trust estate' simply misstates the issue. The issue is the *suitability* of the metric, not its meaning. The problem the first measure was really trying to articulate is the consequence of using shares in 'income' as the basis for attributing the liability to tax. It is not about the meaning of 'income'; it is about the metric of 'income.' And it is hard to see how *Bamford* uncovered anything not known already about the impact of using shares in 'income' as the basis for attributing the liability to tax.

Problem No 2. The second area, again apparently identified in the Board's report, required an amendment:

> to enable streaming of capital gains and franked distributions to beneficiaries. Before the *Bamford* case, trusts commonly streamed income to particular beneficiaries and the Government wants to ensure that this flexibility can continue.[65]

By the time the streaming measure was enacted in June 2011, the Explanatory Memorandum asserted the issue was actually character retention:

> 2.8 The decision has also raised issues about how the proportionate approach interacts with other areas of the tax law. For example, it is not clear how the proportionate approach interacts with provisions in the tax law that assume, or provide for, amounts (such as capital gains and franked distributions) to have the same character in the hands of a beneficiary as they had in the hands of a trustee.[66]

Again, it is interesting to observe the vacillation in stating what the problem is: in March the problem was doubts about the ongoing ability to stream income; in June, the concern was doubts about retention of character in the hands of beneficiaries.

It is hard to see how *Bamford* says anything at all about streaming or character retention.[67] Again, the argument that *Bamford* creates difficulty for

---

[63] Treasury, 'Improving the Taxation of Trust Income' (Discussion Paper, Treasury, March 2011) <http://www.treasury.gov.au/~/media/Treasury/Consultations%20and%20Reviews/2011/trust%20income%20tax/Key%20Documents/PDF/Discussion_paper_Improving_the_taxation_of_trust_income.ashx>.

[64] Explanatory Memorandum, Tax Laws Amendment (2011 Measures No 5) Bill (Cth) [2.7].

[65] Shorten, above n 60.

[66] Explanatory Memorandum, Tax Laws Amendment (2011 Measures No 5) Bill (Cth) [2.8].

[67] This claim, that *Bamford* undermines streaming, appears to have come from the Board of Taxation's report, although until the report is released this is speculation. The impetus may have

streaming misstates the High Court's judgment. The argument was that the word 'share' had now come to mean something more than the metric which provided the numerator for calculating a fraction. 'Share' had now assumed a life of its own and beneficiaries were to be treated as 'sharing' in the undifferentiated income of the trust. The Explanatory Memorandum to the No 5 Bill put it this way:

> On one view, the result of [adopting the proportionate meaning of the word 'share'] is that a beneficiary includes a 'blended' amount of all of the different types of income and capital gains included in the trust's taxable income.[68]

The inability to articulate consistently what problem or problems *Bamford* revealed perhaps indicates a degree of confusion.

The ATO's determination to constrain the meaning of the word 'income' cannot, it seems, be thwarted. A new version has been developed. A draft ruling issued in March 2012 again attempts to constrain the meaning of the word 'income' and its implications for allocating tax liabilities by insisting that the meaning is externally dictated. Draft Ruling TR 2012/D1 proposes a new meaning for the word 'income' which operates, 'notwithstanding how a particular trust deed may define income …'.[69] The ruling takes the view that one can infer the whole or maybe just parts of this externally-dictated meaning from 'the statutory context.' In other words, the ruling asserts that the position articulated by the High Court that 'the undefined expression 'the income of the trust estate' … has a content found in the general law of trusts, upon which div 6 then operates'[70] is not the total story. In fact, it has been overruled by the statute, albeit by implication. So div 6 does not simply use the word 'income'; it modifies the word in the process and gives it a new meaning which governs when applying the tax law.

Again, the draft ruling provoked more than a little controversy. It now seems this second attempt at generating a constrained meaning may be abandoned. The rumour in the profession is that the ATO wrote to delegates to the leading industry liaison group in June 2012, saying it has not yet decided whether the draft ruling will be withdrawn, left in limbo or issued with amendments.

---

come from the ATO although ATO, *Income Tax: Distribution by Trustees of Dividend Income Under the Imputation System*, Ruling TR 92/13, 2 June 2010 (Withdrawn: 22 June 2011) (the ruling in which the ATO acknowledged and regulated the practice of streaming) was not one of the rulings withdrawn in June 2010 when the decision impact statement was issued. Ruling TR 92/13 was not withdrawn until June 2011, by which time its effects had been made redundant by the impending enactment of statutory streaming measures. Practice Statement (General Administration) PSLA 2005/1, 1 September 2005 (withdrawn 13 October 2010) regulated a similar practice when dealing with allocating capital gains.

[68] Explanatory Memorandum, Tax Laws Amendment (2011 Measures No 5) Bill (Cth) [2.9].

[69] ATO, *Income Tax: Meaning of 'Income of the Trust Estate' in Division 6 of Part III of the Income Tax Assessment Act 1936 and Related Provisions*, Draft Ruling TR 2012/D1, 28 March 2012, [13]. The ruling takes the view that one can infer the whole or maybe just parts of this external meaning from 'the statutory context'. Read through this prism, the 'income' of a trust has three aspects: it must be measured in respect of distinct years of income, a product 'of the trust estate', and an amount in respect of which a beneficiary can be made presently entitled: see [8]. These three ideas have to be inferred because none appears in the legislation.

[70] *Bamford* (2010) 240 CLR 481, 505 [36].

4 *June 2011 Measures*

Whether or not *Bamford* added to our store of uncertainty is now beside the point. Two amendments to *ITAA 1936* div 6 were enacted in June 2011.

The first was the enactment of the 'temporary' streaming measures in June 2011 with effect from the 2010–11 year of income. These provisions create a parallel world for franked dividends and capital gains. The legislation was amended to include franked dividends and capital gains directly in the assessable income of a beneficiary where the beneficiary is 'specifically entitled' to this kind of income.[71] The amount of franked dividends or capital gain so included is based on the 'share' of capital gain or dividend which the beneficiary is entitled to receive. The tax on other kinds of trust income, and on franked dividends and capital gain where no beneficiary is 'specifically entitled', is still allocated between beneficiaries using the existing notions of present entitlement to a share of the income of the trust estate.

The second amendment is more interesting. The aborted 'net income' project had metamorphosed into two rules in *ITAA 1936* ss 100AA and 100AB. In many respects they are much better targeted and get closer to real mischief which should be proscribed:

- where a tax exempt is presently entitled to a share of the net income of the trust estate and the trustee has failed to notify the exempt entity in writing of the present entitlement, or pay the amount to the exempt entity, within two months after the end of the income year; and
- where a tax-exempt entity is made presently entitled to a share of the net income of the trust which is not reflective of the economic value of the entity's trust entitlement.

Where either rules is triggered, the exempt entity is deemed not to be presently entitled to the relevant amounts, with the intended consequence that the trustee will be liable to tax on that income at the top personal marginal rate.

5 *The New Div 6*

The two June 2011 amendments were interim stages in the creation of a new div 6, which has progressed in fits and starts since December 2010. The main events in this project are the original announcement in December 2010, the net income project and accompanying discussion paper, 'Improving the Taxation of Trust Income' (March 2011),[72] which was terminated in April 2011, and the consultation paper, 'Modernising the Taxation of Trust Income' (November 2011).[73]

---

[71] The term 'specifically entitled' is intended to identify those circumstances where the trustee has the power under the deed to stream income of various kinds between beneficiaries.

[72] Treasury, above n 63.

[73] Treasury, above n 34.

The November 2011 paper represents the latest statement from Treasury about what the future of div 6 might look like. It is still the only indication of Treasury's approach to the overarching project to 'update' and rewrite the tax provisions for (non-MIT) trusts.

The paper claims, at various places, that the current rules are 'complex,' 'uncertain' and 'lacking clarity' and cites as evidence of this 'continued litigation decades after [the] introduction' of div 6. While there has certainly been a spate of recent trust cases, of which *Bamford* is only one, the paper does not attribute that litigation to equally plausible causes — such as the ATO's decision to test some its newly formed views — although it does concede 'the lack of [a] common understanding' about how div 6 works.

In general terms, the consultation paper is organised around three themes: the principles that should underpin the new regime; the perceived problems with the current provisions and their relative priorities; and possible approaches that a new regime might adopt. The paper takes seriously the fact that the problems with the current law are problems of execution rather than intention. The paper is mostly about how to accomplish what is sought.

The discussion paper sets out five 'principles' which it says are the design features that any trust regime should implement. The first is clearly an echo of the ATO's campaign:

> Tax liabilities in respect of the income and gains of a trust should 'follow the money' in that they should attach to the entities that receive the economic benefits from the trust.[74]

Similarly, at various places throughout the paper, Treasury lists what it sees as the most significant problems with the current law. These include the determination of the 'income' of the trust, especially in cases where the trust deed intervenes to vary the ordinary meaning of the term and confers powers on trustees to determine the amount of income[75] and the way in which the respective 'shares' in that income are to be determined.[76] The paper also notes concerns about character retention of amounts subject to a trust. Again, this is a familiar agenda.

The key part of the paper proposes three possible models for reforming the tax of income flowing through trusts.[77] The third option is to assess beneficiaries only on amounts physically distributed to them (or applied for their benefit) and to assess the trustee on the remainder of a trust's taxable income. This seems to be Treasury's preferred model and its benefits are elaborated at some length. The discussion of this model says simply that many of the problems identified earlier in the paper could be accommodated in such a regime. Streaming would remain feasible; it could be prescribed that income retains its character when distributed.

There is little discussion about the most important issue associated with a distribution-based model — how to 'distribute', in cash or property, items which

---

74 Ibid 2.
75 Ibid 11.
76 Ibid 13.
77 Ibid ch 8.

are mere fictions of the tax system that happen to increase (or decrease) taxable income. The tax system contains many fictitious (or accelerated) inclusions in assessable income which will not necessarily reflect amounts that can be distributed as cash or property, such as franking credits, foreign income taxes paid, taxation of financial arrangements accrual and re-translation amounts and so on. Similarly, tax law has many allowable deductions that do not diminish cash, such as depreciation and capital allowances. The result of this situation is that the relationship between the amount of funds available for distribution and the taxable income of a trust is tenuous. Whether a trust can fully eliminate the entity level tax would thus depend upon the rather fortuitous balance between its tax-generated additional deductions and its tax-generated additional income inclusions (or its willingness to take on debt or return capital to fund adequate levels of cash distribution). This might be solved by tinkering with the computation of taxable income to prevent tax being triggered at the trustee level, but this is not seriously explored in the paper.

What is more interesting is the way the November 2011 paper, targeted largely at private trusts, echoes issues already examined and resolved in the context of a different project — the taxation of MITs. This distribution-based model had been raised in 2008 in the Board's discussion paper:[78]

> [T]he trustee could be assessed on the net income after allowing a deduction for certain distributions made to beneficiaries. This option is referred to as the trustee assessment and deduction model.[79]

That model was discarded by the Board later in the MIT review process in favour of the attribution regime currently being designed. It is more than a little concerning that a model which has already been examined and discarded in the MIT project should be the favoured candidate in the rewritten div 6 project.

There are other echoes of the MIT project in Treasury's November 2011 paper. For example, in the 2008 paper there is a long discussion about the issue of character retention[80] and the possibility of creating a codified regime because of 'the uncertainty about the principle of flow-through in all but simple trusts.'[81]

The story of the div 6 rewrite project exemplifies two of the themes of this comment. It is, in part, a story about the impacts of an activist tax administration pursuing a project to change the accepted law and norms for taxing income derived through trusts. The agency issues announces its disquiet with the law, issues controversial administrative pronouncements, seeks to establish new law though the court system, and when these measures fail, turns its attentions to convincing the government to intervene with legislative measures.

---

78 Board of Taxation, 'Review of the Tax Arrangements Applying to Managed Investment Trusts' (Discussion Paper, Board of Taxation, October 2008) <http://www.taxboard.gov.au/content/reviews_and_consultations/managed_investment_trusts/discussion_paper/managed_investment_trusts_discussion_paper.pdf>.

79 Ibid 22.

80 Ibid 40.

81 Ibid.

The story of the div 6 rewrite project is also about another theme — that of issue duplication, and solution divergence. The ATO and Treasury's preoccupation with income definition, income attribution and character retention, which had been played out and resolved in 2008–09 during the MIT project, resurfaced in 2010 and 2011 in the div 6 project. Paradigms and models which had been rejected in one context are resurrected in another. Whether the div 6 project will reach the same conclusions as the MIT project remains unclear at this stage.

B *Australian Electoral Politics*

The next sections of this paper discuss causes that are evident in several interwoven and overlapping projects, the 'mosaic' of trust reforms referred to in the title. As this analysis evolves, a project that began focussed just on reforming the method of taxing inbound investors will develop a number of separate strands: changes to the classification of income and gains made by certain types of trusts; relaxing the restrictions on the kinds of activities, and ownership structures that constrain the scope of operation certain types of trusts; expanding to the range of trusts whose investors would qualify for this treatment; and changes to the method of taxation of resident investors in certain types of resident trusts.

In order to implement these strands, the project would necessarily involve both amendments to existing legislative regimes and the introduction of measures to create the new 'managed investment trust' concept.

These disparate but related efforts reveal a different impetus from the forces that drove the div 6 rewrite project. The forces which led to these measures start in the campaign for Australia's 2007 federal election and display the bidding wars that can arise as political parties watch, match and then try to outdo each other's policy initiatives.

1 *The s 98 and s 98A System*

Prior to the 1997 election, the system for taxing non-residents with interests in resident trusts was somewhat cumbersome in theory, though less so in practice. As was noted above, trusts are treated as transparent for Australian tax law so that income is almost always taxed in the hands of the investors, not at the level of the trustee. For non-resident investors, however, special rules were (and still are) imposed to shift the taxing point and collect tax before the income leaves Australia. These rules became a source of complaint and fixing them led to this project and the bidding war.

The basic system for collecting tax from non-resident investors into resident trusts operated in two steps.[82] First, tax was formally imposed on the resident trustee requiring it to pay tax on any share of the net income of a trust belonging to a beneficiary which was a foreign resident at the end of the income year — that is, the taxing point was shifted from the non-resident beneficiary to the resident

[82] This regime still applies to trusts which do not fall within the developments about to be described.

trustee.[83] The system was not, in formal terms at least, a simple withholding mechanism because the trustee was made personally liable to pay the tax (not merely liable to collect the debt of another), and was liable regardless of whether it had distributed any amounts to the non-resident.[84]

A second provision then included the same amount in the assessable income of the non-resident beneficiary and, theoretically at least, the non-resident beneficiary was required to file an Australian tax return reporting this income.[85] Again, the amount included in the non-resident's income was not the amount of any cash distribution it had received, but rather the amount the non-resident was entitled to receive. The non-resident beneficiary was then granted a refundable tax credit against its tax liability for the amount of tax paid by the trustee.[86] For most investors, the tax collected by the trustee would equal the beneficiary's Australian tax liability. However, the beneficiary's tax liability was formally imposed on a net basis, not the gross cash payment, so if the beneficiary had expenses properly attributable to its Australian source income — say, interest on money it had borrowed to invest in the Australian trust — a difference might arise and the beneficiary would be entitled to a refund of the excess amount collected from the trustee. Again, as a procedural matter, in order to claim the tax refund, the non-resident would have to file an Australian tax return. (The lore in Australia is that few non-resident beneficiaries ever filed Australian tax returns.)

So, according to the legal niceties, there were two separate obligations to report income and pay tax, both imposed regardless of whether the trust's income was distributed or retained, at rates that differed depending on the type of income and type of beneficiary, against a tax liability calculated on the beneficiary's net position, not gross receipt. In reality, the system operated in most cases as if the amount paid by the trustee were a final withholding tax, extinguishing the non-resident's Australian tax obligations.

2 *The Opening Salvo – the June 2007 Measures*

In the May 2006 Budget, the Howard Government announced that it would change some aspects of the system for taxing non-resident investors who invested in

---

83 *ITAA 1936* ss 98(3)–(4), as in force prior to the *Taxation Laws Amendment (2007 Measures No 3) Act 2007* (Cth). The rate of tax payable by the trustee depended on two factors. The first was the type and source of income which the trust had derived. For example, Australian source interest, dividends and royalties earned by a trust were subject to tax in the hands of the trustee at the same rates as applied under the withholding tax rules to interest, dividends and royalties paid by resident companies. Other kinds of Australian source income were taxed but the applicable rate depended on the nature of the beneficiary. Different rates were prescribed depending on whether the non-resident beneficiary was a company, individual or another trustee. Foreign companies were taxed at a flat rate of 30 per cent, but foreign individuals were taxed at progressive rates from 29 per cent to 45 per cent.

84 In fact, most trusts, especially those with a significant number of retail or non-resident investors, would distribute cash regularly and the possibility of the trustee having to pay tax on retained income rarely arose.

85 *ITAA 1936* s 98A(1) as in force prior to the *Taxation Laws Amendment (2007 Measures No 3) Act 2007* (Cth).

86 *ITAA 1936* s 98A(2) as in force prior to the *Taxation Laws Amendment (2007 Measures No 3) Act 2007* (Cth).

certain kinds of Australian trusts; the system for taxing resident investors would remain unchanged. The Treasurer's press release proposed:

> [S]implifying the tax collection mechanism for taxable income distributed to non-residents by Australian managed funds … by replacing a number of tax collection regimes with multiple rates with a single tax collection regime with a single rate … Current withholding tax arrangements for dividends, interest and royalty income of non-residents will not be changed.[87]

Legislation to give effect to this announcement was eventually introduced into Parliament in May 2007 and received Royal Assent in June 2007.[88]

The 2007 change was very modest — it imposed a flat rate withholding regime at the rate of 30 per cent in lieu of the differentiated rates that had applied. The minor nature of the change is seen in various places: the withholding regime remained a tentative collection; non-resident investors were still independently taxable and obliged to file Australian tax returns; the announcement primarily affected non-resident individuals and trustees as non-resident companies were already taxed at the 30 per cent rate; the 30 per cent rate was still only applicable to certain components of trust distributions; that is, to the extent that the distribution represented dividends, interest and royalties earned by the trust, these remained taxable at a different rate; foreign source income was excluded, and so too were capital gains that were outside Australia's claimed jurisdiction to tax; and the regime was only applicable to distributions made by certain types of trust, to be labelled 'managed investment trusts'.[89]

Although this change was rather modest in its immediate effect, its lasting significance was in establishing a number of design features that would survive and become entrenched in what would follow.

3 *The Reply*

In contrast to this tardy legislative activity, another part of the story was being developed by the then opposition. In an April 2007 speech to the Sydney Institute, the Shadow Treasurer offered to match, and even exceed, the proposal that the government had announced but not yet delivered: a future Australian Labor Party ('ALP') government would impose a 15 per cent flat rate withholding tax on trust distributions, rather than the 30 per cent rate which the government had announced; and the withholding would be a final tax, eliminating the need for foreign investors

---

87 Peter Costello, Treasurer, 'Further Measures to Simplify and Streamline the Tax System' (Press Release, No 39/2006, 9 May 2006) <http://www.treasurer.gov.au/DisplayDocs.aspx?pageID=&doc=pressreleases/2006/039.htm&min=phc>.

88 *Taxation Laws Amendment (2007 Measures No 3) Act 2007* (Cth) sch 10. Provisions in sch 9 made a number of other amendments, replacing s 98(3)–(4) with ss 98(2A), 98(3), 98(4), amending s 98A and adding s 98B.

89 This term was defined in *Taxation Administration Act 1953* (Cth) sub-div 12-H. In general terms, a trust would be an MIT if, at the time the trustee made the first fund payment for an income year, the trust was resident, it was externally managed, it was an MIS under certain corporate law tests that related to consumer protection and the trust was either listed on a stock exchange or met certain widely held tests.

to lodge an Australian tax return (but also eliminating the ability of non-residents to claim deductions for expenses incurred in earning the distributions).[90]

This proposal was reiterated by the leader of the opposition in his speech in reply to the 2007–08 Budget[91] and became ALP policy for the 2007 election campaign. According to the ALP's press release, the new system would be final, and the need to lodge a tax return and claim debt as a deduction would be abolished. The 15 per cent rate would match the tax regimes in Japan, Singapore, the United States and Hong Kong.

The campaign slogan was that these measures were designed 'to secure Australia's place as a financial hub in the Asia-Pacific.' That is, while the government's version had been directed toward compliance costs — simplifying the computation processes for resident trustees — the opposition's version was about supporting the local funds management industry and encouraging the 'export' of the management expertise to non-resident customers who invested in or through locally-managed funds.

The campaign intensified when the Shadow Assistant Treasurer proposed that the Board should undertake a general review of the entire tax regime for the managed funds industry, including the potential for introducing a dedicated tax regime for Real Estate Investment Trusts ('REITs').[92] He also proposed that, in addition to the broader review, there would be a quick review with a narrow focus aimed at just a few questions: overhauling the range of permitted and forbidden activities; how to handle trusts which control companies engaged in forbidden activities; and the consequences of earning income from prohibited activities.

4 *A New Front – the Reorganisation and Offshore Expansion Amendments*

The Shadow Assistant Treasurer's announcement was followed just a few weeks later by further action from the government, albeit directed at a new issue.[93] The government introduced legislation into Parliament that addressed two aspects of

---

90 Wayne Swan, 'Meeting the Challenge: Labor's Economic Vision for the Future' (2007) 19(2) *Sydney Papers* 132, 140–2.

91 Commonwealth, *Parliamentary Debates,* House of Representatives, 10 May 2007, 129 (Kevin Rudd) (debate on the Appropriation Bill (No 1) 2007–08).

92 Chris Bowen, 'Securing the Future: The Next Step in Labor's Asian Funds Management Hub Policy' (Speech delivered at the Investment and Financial Services Conference, 3 August 2007) <http://www.fsc.org.au/downloads/file/SpeechesFile/2007_0806_ChrisBowen-IFSASpeech-030807.pdf>:

> Today, I can announce that the first reference a Rudd Labor Government will send to the Board of Taxation will be the operation of Division 6C. As part of this reference, we will be asking the Board of Tax to examine the opportunity of a managed investments tax regime in Australia, including the potential for a specific tax regime for REITs. This regime would largely replace the operation of Division 6C as it impacts on your industry.

93 In fact, the government's action had been proposed in April 2007, but was acted upon in August 2007: Peter Dutton Assistant Treasurer, 'Tax Changes to Enhance International Competitiveness of Australian Property Trusts' (Press Release, No 31/2007, 4 April 2007) <http://treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2007/031.htm&pageID=003&min=pcd&Year=&DocType=0>.

the outbound operation of the trust rules; that is, trying to adjust the effects in Australia of a resident trust making offshore acquisitions.[94]

Unlike the ALP's announcements, which were simply aspirations unless it could gain power at the upcoming election, these measures could be executed by the government, and legislation was duly passed in September 2007.

The first measure in the legislation was directed to a resident stapled structure; that is, a resident trust and resident company held in strict common ownership. The legislation proposed allowing the reorganisation of the stapled structure to interpose a new head trust between the investors and the trust and company. The new trust could acquire the stapled interests from the investors and issue units in itself to the investors in exchange, without triggering Australian CGT for the investors.

Changing the domestic tax consequences of this transaction was not, in fact, the motivation behind the legislation. Rather, it was directed toward a subsequent transaction and addressing the anticipated tax effects under foreign law of the second transaction. The legislation was based on the hypothesis that an Australian trust with an existing stapled structure would be at a competitive disadvantage when bidding for an offshore entity, such as a United States REIT. The assumption was that the existing owners of the REIT would likely be able to exchange their interests in the REIT for interests in a rival but unstapled bidder without triggering a tax liability in their own country. Owners who exchanged their interests for the multiple interests issued by an Australian stapled entity might receive only a partial rollover, meaning the rival's offer was more attractive. The new structure would remove this impediment, permitting the restructuring so that a single entity could offer interests in itself as consideration in an offshore acquisition.[95]

A related measure in the legislation then had to adjust some of the other tax consequences in Australia where a trust undertook the reorganisation to establish this new structure. After the reorganisation had occurred, the newly created resident trust now controlled a company, probably undertaking offending activities, and exposing the new trust to the very tax consequences which the stapled structure had been designed to avoid. The legislation, therefore, removed this exposure by switching off the activity test rules, but only where this very fact pattern existed — an interposed trust was created as part of the restructuring of stapled entities, a tax rollover was obtained, and the only offending activity which a trustee undertakes is owning shares in a company that was one of the stapled entities.[96]

---

[94] *Tax Laws Amendment (2007 Measures No 5) Act 2007* (Cth).

[95] Explanatory Memorandum, Tax Laws Amendment (2007 Measures No 5) Bill 2007 [8.5]:

> To enable Australian Listed Property Trusts to acquire overseas vehicles in exchange for their own equity, it is often necessary for the acquirer to issue only its own equity… In this respect, a stapled Australian Listed Property Trust is at a competitive disadvantage to a single entity seeking to acquire US Real Estate Investment Trusts. This is because the interest holders of the target Real Estate Investment Trust would be entitled to a CGT roll-over in the US if the acquirer was offering only its own equity but not if the acquirer was offering a combination of its own equity with other equity.

[96] *ITAA 1936* s 102NA.

A second measure in the legislation was rather more fundamental, reconceptualising the proper scope of these activity restriction rules.[97] It was not tied to the restructuring aspects of the package. It was deliberately designed to permit the offshore expansion of Australian property trusts.

The legislation switched off the activity restriction rules where an Australian trust acquires or controls an offshore company (or group of companies), provided the target is principally involved in investing in land.[98] While the target entity might enjoy flow-through treatment in its own country, if Australia's activity restrictions were more tightly drawn, the acquisition of the foreign company might expose the Australian trust to the operation of Australia's activity restriction rules. In other words, the Australian trust is exposing itself to some danger by acquiring the United States REIT. The activity restriction rules are designed to protect the Australian corporate tax base; it is not obvious that they need to be applied where an Australian trust owns or controls a foreign company with no exposure to, and thus no real incentive to try structure its way around, the Australian corporate tax.

The new provision switched off the activity restriction rules where a resident trust owned shares in a foreign company that conducted some minor extraneous activities or owned a subsidiary which conducted some minor extraneous activities.

5 *The Election Victory*

The ALP won the November 2007 election and set about giving effect to election promises. On 22 February 2008 the Assistant Treasurer announced that the government had asked the Board to undertake the promised general review of the tax treatment of managed funds.[99] In the May 2008 Budget, the government implemented, with revisions, its promised MIT model: the 30 per cent tentative withholding would still be replaced with a lower final tax, but the government would both expand and narrow its benefits. First, access to the lower rate of tax would now be qualified according to whether the foreign investor was resident in a jurisdiction with which Australia has an effective exchange of information arrangement. Residents of other countries would be liable to tax at 30 per cent. Second, the government surprised the market by announcing that the proposed 15 per cent rate would be reduced to 7.5 per cent, although transition to the new final rate would be staggered.[100] The legislation was passed almost immediately in June 2008 and began operating for payments made in relation to the 2008–09 income year.[101]

---

97 Ibid s 102N(2).

98 The legislation was designed to accommodate two distinct situations: if an Australian trust acquired shares in a foreign company that conducted some modest activities that are prohibited under the Australian test, and if an Australian trust acquired shares in a foreign holding company with a subsidiary that conducted some modest activities prohibited under the Australian test.

99 Chris Bowen, Assistant Treasurer, 'Board of Taxation to Review Tax Arrangements Applying to Managed Funds' (Press Release, No 10/2008, 22 February 2008) <http://www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2008/010.htm&pageID=003&min=ceb&Year=&DocType=0>.

100 The rates were 22.5 per cent non-final withholding tax for fund payments of the 2008–09 income year; 15 per cent final withholding tax for fund payments of the 2009–10 income year; and 7.5 per cent final withholding tax for fund payments for the 2010–11 income year and beyond.

101 *Income Tax (Managed Investment Trust Withholding Tax) Act 2008* (Cth).

The ALP had implemented its 2007 election promises and more, but the thrust and parry of election bidding had produced a very unusual outcome. The 7.5 per cent for distributions from MITs was a remarkably low rate, given that this rate would be applied largely to rental income and profits on sales of land and securities.[102] It is odd to realise that Australian politicians had bargained away any significant tax on one of the most fundamental and uncontentious parts of Australia's tax base — taxing income and gains from renting and selling Australian land. Australia now had a higher tax rate on interest income and portfolio dividends than it did on income from Australian land, a tax base which would seem to be much less mobile and thus much more capable of sustaining higher rates.

Perhaps it is not surprising, therefore, that free from the influence of electoral politics, the 7.5 per cent rate operated for only three years. In the 2012–13 Budget, the Treasurer announced that the rate would be increased to 15 per cent. This has now been enacted for MIT distributions of trust income attributable to the 2012–13 income year and beyond.[103]

C Industry Lobbying

The influence of the managed funds industry and the property industry represent another force driving the disparate trust reform projects. Their lobbying had undoubtedly guided the political parties' bidding wars but perhaps not surprisingly, having won that campaign, they continued lobbying for other changes: relaxing the activity restrictions on widely held trusts; ensuring the attractive characterisation of gains and losses for investors; and expanding the range of trusts whose investors would qualify for these benefits.

As noted above, the Assistant Treasurer had asked the Board to undertake a general review of the tax treatment of managed funds in February 2008.[104] The

---

[102] The portion of an MIT distribution which consists of dividends, interest and royalties was excluded from this regime and remained subject to the withholding tax rates applicable to that kind of income. For many MITs the remaining components of the MIT distribution was principally net rent and profits from sales of equities, bonds and real estate.

[103] *Tax Laws Amendment (Managed Investment Trust Withholding Tax) Act 2012* (Cth); *Income Tax (Managed Investment Trust Withholding Tax) Amendment Act 2012* (Cth). In one curious development, the government agreed, during the passage of the Bills through the Parliament, to have a special 10 per cent rate for distributions from, 'managed investment trusts that only hold newly constructed energy efficient commercial buildings': David Bradbury, Assistant Treasurer, 'Withholding Tax Bill Wins Senate Support' (Press Release, No 53/2012, 27 June 2012) <http://assistant.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2012/053.htm&pageID=003&min=djba&Year=&DocType=0>. This was apparently the price of securing the support of The Greens. An Exposure Draft of legislation to give effect to this modification was released by Treasury on 16 August 2012: Exposure Draft, Tax Laws Amendment (Clean Building Management Investment Trust Bill (2012) <http://www.treasury.gov.au/ ConsultationsandReviews/Submissions/ 2012/Clean-MITS-10-per-cent-concessional-tax-rate>.

[104] Under the terms of reference, the Board was asked to review the current income tax arrangements applying to MITs and to develop options for the reform of the taxation treatment of trusts broadly consistent with existing principles for taxing trusts. This constraint referred to three design features of Australia's trust tax system. The transparency paradigm would be retained as far as possible but transparency would be limited, in the case of widely held trusts, to 'trusts undertaking activity that is primarily passive investment'. Beneficiaries would be assessable on their share of the net income

Board was asked consider options which would 'reduce complexity, increase certainty and minimise compliance costs', and to reconsider the activity restriction rules and the costs and benefits of establishing a separate taxing regime for REITs, modelled on comparable international regimes. The property industry and the managed funds industry were key industries affected by this project and were, not surprisingly, a significant force in redirecting its agenda, shaping its timetable and influencing its recommendations.[105]

1 *The Property Industry's Focus on Activity Restrictions*

While the rules about offshore activities had been relaxed in September 2007, the restrictions surviving in the tax law discouraged widely held trusts from undertaking onshore activities other than holding real estate, shares and debt securities.[106] Breaching this rule would trigger tax on the trust's taxable income at the corporate rate. In effect, the trust would now be providing post-tax distributions to investors.

The property industry, in particular, argued that these rules were overly-restrictive. Widely-held trusts were limited to 'investing in land ... primarily for the purpose of deriving rent', a formula that created potential problems where other activities generated even modest amounts of non-rental income.[107] The property industry had long been concerned about the way in which these tests limited new business opportunities and did not reflect modern property ownership and management practices. Were amounts received for granting non-exclusive occupancy licences for moveable coffee carts or parking spaces 'rent'? Was a lump sum fee received for granting a licence to erect a mobile phone tower on the roof 'rent'? If the basement car park were subcontracted to a commercial car park operator who paid a fee for the right to operate the car park, was this 'rent'? If the owner leased a shop already fitted out to an occupant was the money received still derived from 'land'? The roof space could not be used to generate and sell solar power because the sale proceeds were presumably not rent. Would this still be the case if the roof space was used to generate solar-powered hot water which was supplied to tenants for an increased rent? These opportunities could be argued not to be inconsistent with the idea behind the activity restrictions, but the drafting would not seem to allow them and the consequences of breaching the rule were serious.

Industry argued that the test should be relaxed to accommodate modern practices and many proposals had been floated over the years about how this might be done — the test might be treated as satisfied if the total prohibited income fell

---

whether or not distributed to them, with the trustee liable to tax any on net income not assessable to beneficiaries in a year — eg, cases where no beneficiary can be identified as the beneficial owner of this income. Third, losses in any year would be trapped in the trust and not be available for use by the beneficiaries.

[105] The list of contributors to the Board's deliberations shows the preponderance of submissions came from fund managers, the finance industry, superannuation funds, the property industry, tax advisers and their professional bodies. See Board of Taxation, above n 78. No submissions were made by industrial, commercial or trading firms.

[106] *ITAA 1936* divs 6B–6C.

[107] Ibid s 102M, definition of 'eligible investment business.'

within a safe harbour amount, perhaps offending income types rather than permitted income might be specified, any breach of the rule would affect only the offending income, and so on.

Another part of the same test triggered adverse tax consequences if the trust controlled a company undertaking offending activities.[108] This meant that a trust was prevented from isolating offending activities in a tax paying company. In practice, this led to complex stapled structures where investors owned dual interests in both a trust and a company. Again, industry argued that a trust should be able to establish a taxable corporate subsidiary to isolate any offending income, without jeopardising its own position.

These were the kinds of dilemmas that the industry had put to government and which the Assistant Treasurer referred to the Board in February 2008. At the time of that announcement, the new government released a consultation paper,[109] outlining a series of possible 'interim' changes to the taxation of trusts which might be enacted and apply until the Board finalised its longer-term review. Three key measures foreshadowed in the paper were: clarifying the scope and meaning of the basic test for real estate trusts; creating a 25 per cent safe harbour for non-rental income; and expanding the range of financial instruments that a trustee could trade or invest in — a measure that was more relevant to the managed funds sector.[110]

In July 2008, after consultation on Treasury's *February Paper*, the government released draft legislation for the proposed interim adjustments to the activity restriction tests.[111] The amendments generally followed the approach already foreshadowed in the *February Paper*: the meaning of 'land' would be widened to include fixtures on land and chattels that are customarily supplied, incidental and relevant to the renting of the land and ancillary to the ownership and utilisation of the land;[112] a 25 per cent safe harbour would be created — that is, trusts which invest in land could earn up to 25 per cent of their gross revenue each year in a form other than rent[113] — however, the safe harbour could not include revenue from a new category labelled 'excluded rent' nor revenue from 'carrying on a trading activity on a commercial basis'.[114] One new measure not foreshadowed in the *February Paper* was an additional two per cent per annum safe harbour: a trust could derive up to two per cent of its gross revenue each year

---

[108] Ibid s 102N(1)(b). This rule was necessary to buttress the activity restrictions because investing in shares to derive dividend income was permitted. Without such a rule, the offending activity could be put in a subsidiary, the profits could be paid to the trust as a dividend and the trust would not offend the activity test.

[109] Treasury, 'Potential Changes to the Eligible Investment Rules for Managed Funds, Including Property Trusts' (Industry Consultation Paper, Treasury, 2008) ('*February Paper*').

[110] Bowen, above, n 99.

[111] Exposure Draft, Tax Laws Amendment (2008 Measures No 5) Bill 2008.

[112] This proposal became amendments to definition of 'land' in *ITAA 1936* s 102M, and the insertion of *ITAA 1936* s 102MB(1).

[113] This proposal became *ITAA 1936* s 102MB(2)–(5).

[114] 'Excluded rent' was defined to mean turnover-based rent between associates, or rent based on profit or net receipts 'that would result in those profits or receipts being transferred wholly or substantially to another party'. This exception was made part of *ITAA 1936* s 102MB(2) and a new definition, 'excluded rent' was inserted in *ITAA 1936* s 102M.

in a form other than rent although, again, this concession would not apply if the revenue is from 'carrying on a trading activity on a commercial basis'.[115]

The draft legislation created something of a furore in the industry because of the tightness of the drafting, and some modest changes were made to the final version that was eventually introduced into the Parliament in September 2008. For example, the prohibition on turnover-based rent between associates was removed. The final version was passed in December 2008, although its effect was backdated to the start of the 2008–09 year.[116]

By December 2008, industry had succeeded in having some relaxation of the former strictness of the activity restrictions, in addition to the restructuring and offshore expansion amendments enacted in 2007.

2 *The Funds Management Industry's Concerns about Character*

The Assistant Treasurer's February 2008 press release and the accompanying Treasury consultation paper had proposed amendments intended for the funds management industry. The paper proposed, 'expanding the range of financial instruments included in the definition of eligible investment business that the trustee can invest or trade in'.[117]

The proposal presumed that the concern of the funds management industry was constraints created by the activity restrictions. For managed funds, the scope of permitted activities specified in the law extended to, 'investing or trading in any or all of' debt instruments, shares, units in trusts, forwards, futures, currencies and 'similar financial instruments'.[118] The permitted asset classes were quite broadly drawn and, given that managed share and bond funds were allowed to 'trade' as well as invest, it is not surprising there is no evidence that the industry was seriously concerned about the impact of the restriction.

Instead, the funds management industry had real concerns about the character of gains and losses made by trusts on realising fund assets. Because of the transparency paradigm, the treatment of trust beneficiaries depends on the character — revenue or capital — of gains and losses on the realisation by the trustee of trust assets. The tax effects of transactions with trust assets are simply ascribed to the beneficiaries.

Hence there is a danger underlying a transparency model where trustees, particularly of actively managed share and bond funds, use sophisticated trading models and churn large portions of their portfolio each year.[119] There had been a fear since at least 2005 that the size and scale of the trading activities of managed funds might soon be treated by the ATO as generating ordinary income. Investors in managed funds, especially retail investors, typically buy to hold — they do not

[115] This proposal became *ITAA 1936* s 102MC.
[116] *Tax Laws Amendment (2008 Measures No 5) Act 2008* (Cth) sch 5.
[117] Treasury, above n 109, 1, 6.
[118] *ITAA 1936* s 102M (definition of 'eligible investment business').
[119] This is not typically an issue for property funds where the fund will usually possess just a few large and illiquid assets.

trade their interests in the fund on a regular basis, especially in unlisted funds where the method of exit is by redemption. Investors would ordinarily be seen as generating capital gains and losses if and when they decide to leave the fund. Hence there was a potential mismatch between the characterisation that might be applied if one were to focus on the activities of trustees regularly buying and selling underlying assets, and the character that might be applied if one were to focus on the activities of beneficiaries who buy to hold.[120]

There is a further impetus peculiar to Australia. Australia imposes tax on the earnings of superannuation funds but the Act deems that the gains and losses on many asset classes held by superannuation funds are to be treated as capital gain or loss.[121] Hence, if a superannuation fund bought a portfolio of shares directly, any gain or loss on the sale of the shares would be capital in nature. But if the fund bought an interest in a managed fund which owned the same portfolio of shares, it was not certain that any gain or loss on sale made by the manager of the fund would be treated as capital in the hands of the superannuation fund. The character of the gain would be dictated by the activities of the investment fund manager, not the trustee of the superannuation fund. Hence, the tax system created a bias for superannuation funds to avoid acquiring assets though managed funds.

Issues of characterisation also have special significance for non-resident investors in Australian funds. Luring foreign investors into Australian funds was seen as one of the big growth opportunities for expanding the industry. Australia's claim to tax non-residents on gains made when trustees realise trust assets depends critically on whether the profit in question is regarded as capital or revenue in nature under Australian law. If the profit made on realisation of the trust asset is regarded as capital in nature, Australia's domestic CGT rules assert a narrow jurisdiction: Australia only claims tax from non-residents on capital gains made on the realisation of trust assets which are land (including land held indirectly through companies), mining and petroleum rights and output, and assets used in conducting a permanent establishment in Australia.[122] Hence, treating gains and losses made on most equity interests in companies and trusts as capital gains effectively removes them from Australian tax.

These three structural elements coalesced into a single imperative for the funds management industry, but resolving the character of gains and losses made by managed trusts on their assets was not mentioned in Treasury's February Consultation Paper. The funds management industry redirected the Board's

---

[120] This issue had been addressed by the ATO in 2005 in respect of listed investment companies. See Ruling TR 2005/23, 21 December 2005. This ruling served to remind the managed funds industry of its own precarious position. The possible extension of the ruling to managed funds was apparently discussed at the NTLG in November 2007. See Dowd, above n 7, 100. See also Andrew Mills, 'The Capital-Revenue Debate and the Managed Funds Review' (2009) 12 *Tax Specialist* 223, 229–31, 235–6, discussing the responses of the tax profession to Ruling TR 2005/23. Mills also notes the existence of a draft Taxation Determination, prepared in 2008, examining the same issue in the context of managed funds, but which was never publicly released: at 232.

[121] *ITAA 1997* s 295–85.

[122] Ibid ss 855-10, 855-15.

attention toward this problem. It was prominent issue by the time the Board released its discussion paper in October 2008.[123]

The Board's paper raised the possibility of a statutory override on the character question and asked for preliminary submissions just on this topic. The general tenor of the argument was that focussing on the activities of the trustee was counterproductive. If investors would receive capital gain treatment for direct investment but not for pooled investments, the tax system encourages them into direct investment and discourages them from having access to the professional management and risk-spreading that managed funds offer.

Not surprisingly, the Board's proposal was warmly received. Indeed, the industry apparently convinced the Board that this issue was so important it should be accelerated. The Board excised this issue from the larger review of MITs it was still undertaking and made interim recommendations to the government in December 2008 to the effect that managed funds should be allowed to elect for exclusive CGT treatment of trust assets.[124] In the May 2009 Budget the government announced that the recommendation had been accepted and the change would be legislated.[125] Exposure Draft legislation to give effect to this measure was released for comment on 10 December 2009.[126] The text, which was modelled on the equivalent regime for superannuation funds, contained a few surprises and added some confusion about the range of entities that would qualify for capital gain treatment.

After several months' consultation on the Exposure Draft, a Bill was introduced into Parliament on 10 February 2010 containing the final form of the measures that permit eligible managed investment trusts to elect to apply the CGT regime as the primary measure for taxing gains and losses on assets. The Bill incorporated a number of changes from the Exposure Draft which extended the range of trusts eligible to make the election. It was enacted and received Royal Assent in March 2010.[127]

The regime offers trustees of qualifying trusts an irrevocable election to treat gains and losses on certain assets as capital gain or loss.[128] The range of assets to which the effects of the election would extend mirrored the equivalent provision for superannuation funds.[129] If the election is not made, the trust will be treated as

---

123 Board of Taxation, above n 78, ch 7. The Board had apparently approached the Assistant Treasurer and confirmed that the capital versus revenue distinction was within the scope of its review notwithstanding that the issue was not mentioned in the Treasury's February 2008 Paper.

124 See Board of Taxation, *Review of the Tax Arrangements Applying to Managed Investment Trusts — A Report to the Assistant Treasurer* (Board of Taxation, August 2009) 33–4: '[T]he Board's interim advice was provided to the Assistant Treasurer and Minister for Competition Policy and Consumer Affairs in December 2008 following receipt of interim submissions on the issue and some stakeholder consultations'.

125 Chris Bowen, Assistant Treasurer, 'Next Major Steps to Promote Australia as a Regional Financial Hub' (Press Release, No 49/2009, 12 May 2009) <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2009/049.htm&pageID=003&min=ceb&Year=&DocType=0>.

126 Exposure Draft, Tax Laws Amendment (2010 Measures No 1) Bill 2010.

127 *Tax Laws Amendment (2010 Measures No 1) Act 2010* (Cth) sch 3.

128 *ITAA 1997* div 275-B.

129 Capital gain and loss treatment would apply to transactions with most equity interests in companies and trusts and land, including options over equity and land, but would not extend to debt.

making income or deductible loss from most assets other than land and options over land. The tax treatment of land and options will continue to be determined in accordance with the current law on drawing the capital versus revenue distinction.

3 *A Shared Concern – Expanding the Range of MITs*

These victories for the property and funds management industries (especially the final flat rate 7.5 per cent withholding tax on MIT distributions and the availability of the CGT election) made MITs a very attractive vehicle both for residents and non-residents investing in Australia. Not surprisingly, therefore, both the property industry and the funds management industry kept pressing the government to expand the range and nature of the entities that would be able to access these benefits. It seems the industry's efforts met with some success as the definition has been subject to much tinkering. The definition of 'managed investment trust' has undergone at least three significant revisions.

The original definition had been enacted in 2007 in order to give effect to the administration of the MIT withholding tax regime.[130] Once the ALP won the November 2007 election, it became apparent that further changes would be made. Amendments were enacted very quickly by the new government — the entire subdivision in the *Taxation Administration Act 1953* (Cth) was replaced in time for the 2008–09 income year.[131]

The next step in the ongoing efforts to relax the restrictions on the trusts eligible to MITs was the announcement by the Assistant Treasurer in February 2010 that there would be further adjustments to the definition.[132] The Assistant Treasurer announced that the existing definition of MIT used for the purposes of the tax collection rules, and upon which the definition in the capital gain rules depended, would shortly be amended again, in part to achieve a more unified definition throughout the Act.

In May 2010, the full report of the Board into the taxation of MITs was released by the Assistant Treasurer together with the government's response.[133] Less than three weeks later, the Assistant Treasurer announced that there would be a new definition of MIT.[134] A Bill to enact this new definition was introduced into

---

[130] *Taxation Administration Act 1953* (Cth) sub-div 12-H, inserted by *Tax Laws Amendment (2007 Measures No 3) Act 2007* (Cth) sch 10. The provisions began operation from the start of the 2007–08 income year.

[131] *Tax Laws Amendment (Election Commitments No 1) Act 2008* (Cth).

[132] Nick Sherry, Assistant Treasurer, 'Major Reforms Finalised to Tax Treatment of Managed Investment Trusts' (Press Release, No 21/2010, 10 February 2010) <http://www.dpm.gov.au/DisplayDocs.aspx?doc=pressreleases/2010/021.htm&pageID=003&min=njsa&Year=&DocType=0>. The main focus of the Press Release was the introduction of the Bill to give effect to the CGT election, but at the same time the Assistant Treasurer also announced 'further measures to complement this Bill through the expansion of the definition of a MIT'.

[133] Board of Taxation, Nick Sherry, Assistant Treasurer, 'New Tax System for Managed Investment Trusts' (Press Release, No 86/2010, 7 May 2010) <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2010/086.htm&pageID=003&min=njsa&Year=&DocType=>.

[134] Nick Sherry, Assistant Treasurer, 'New Definition of Managed Investment Trust' (Press Release, No 118/2010, 26 May 2010) <http://www.treasurer.gov.au/DisplayDocs. aspx?doc=pressreleases/2010/118.htm&pageID=003&min=njsa&Year=&DocType=>.

Parliament in late May 2010. It was subject to ongoing consultations during its passage through Parliament with amendments inserted in late June. The Bill was finally settled and passed both Houses on the last day of the Winter sitting, receiving Royal Assent on 29 June 2010.[135]

Much of the effort invested since 2007 into changing the MIT definition was directed at removing limits dating back to the original design. The intention of the MIT definition was said to be to target Australian resident trusts with four key characteristics: day-to-day management of the trust assets was not conducted by the investors themselves; the trust was widely held; investors' contributions were pooled and managed jointly; and the managers invested those funds in asset classes which generated passive income such as dividends, interest and rents.[136] There was repeated lobbying to relax aspects of the legislated definition which were said by industry to be misconceived or mis-targeted. There were two main objectives to the lobbying. The first was to ensure that the trusts in which MITs invested would also qualify as MITs; the benefits of MIT status for a head trust would be irrelevant for income derived from non-MIT sub-funds. The second was to allow greater opportunities for non-resident institutions undertaking substantial projects in Australia to use the MIT form. This meant trying to relax the parts of the MIT definition which insisted that the trust represented the pooled contributions of a significant number of investors, was widely held and had external management.

The original 2007 definition used two tests to identify that the trust in question was a pooled investment with external management. The first test was that the trust was 'a managed investment scheme (as defined by the *Corporations Act 2001* (Cth) s 9 ('*Corporations Act*'))' and the second was that the trust was 'operated by a financial services licensee.'[137] The definition of 'managed investment scheme' in the *Corporations Act* exists principally for consumer protection purposes, and relying on it no doubt seemed sensible and convenient at the time. It comprises three elements: several people contribute money to acquire interests in the benefits produced by the scheme, the contributions are pooled and used in the common enterprise and the members do not have day-to-day control over the operation of the scheme.

Additional requirements were imposed under the *Corporations Act* for a MIS to be registered.[138] Registration was needed if the fund was to be marketed to households and many MIS were not registered because they did not need to be. However, a debate quickly ensued between industry and the ATO about whether the tax drafting required both that the trust was a MIS and that it was registered.

This debate was manifest in issues about how to treat wholesale funds. Retail funds often hold their assets through several layers of trusts — an 'Australian share fund' for example, would often consist of units in a trust, and it is this sub-trust which actually holds the Australian shares. The wholesale fund would not be registered because it did not need to be — none of its investors were

---

[135] *Tax Laws Amendment (2010 Measures No 3) Act 2010* (Cth).
[136] Explanatory Memorandum, *Tax Laws Amendment (Election Commitments No 1) Act 2008* (Cth).
[137] *Taxation Administration Act 1953* (Cth) sch 1 s 12-395(1) item 2.
[138] *Corporations Act* s 9: definition of 'managed investment scheme' and definition of 'registered scheme.'

households. But if that trust were not a MIT, the benefit of deemed CGT treatment, for example, for the retail trust would be rather pointless. The retail trust and its investors would still be exposed to the behaviour of the trustee of the wholesale fund.

A similar problem arose for trusts with just a few wholesale investors — say, a property developer, the project financier and one or two institutional investors such as foreign pension funds. Such a trust might in fact pass the test of being widely-held if one of the investors was a foreign pension fund, but if it were not also a MIS and registered, it would not qualify as a MIT for tax purposes. This kind of situation would rarely be registered as it would be under the day-to-day control of members, and the responsible entity would not need to be a licensed entity. In essence, industry was seeking to bring under the MIT umbrella situations where just a few non-residents would establish and conduct a significant investment for their own benefit.

Similar pressure was brought to bear on the separate part of the MIT definition which captured the requirement that the trust be 'widely-held'. The MIT definition contained several alternatives to demonstrate that the trust was widely-held. One was that a fixed trust had 50 members. A second option was that the trust was listed on an approved stock exchange but the listing option did not automatically include every wholly-owned 'subsidiary' of a listed trust. Again, if the wholly-owned but unlisted trust were not a MIT, the benefit of deemed CGT treatment for the listed trust could be pointless.

The third way of satisfying the widely-held test was if any units in the trust were held by a life insurance company, a foreign MIS with at least 50 members, or a local or foreign superannuation fund with at least 50 members. The choice of life insurance company no doubt reflected a view that these institutions in fact represent at least 50 people. This was presumably a proxy for any form of tracing regime which might have allowed the trustee of the trust to look through its immediate owners to establish whether the requisite level of ownership (50 members) had been met.

The 2008 amendments made no significant changes to this part of the definition but the 2010 amendments did. One of the key changes introduced by the 2010 definition was having separate MIT criteria according to whether the trust operates at a retail or wholesale level, relaxing the rules which operate when a MIT is owned in part by another type of collective investment vehicle (such as a life insurance company, superannuation fund or other MIT), expanding the range of vehicles considered to be collective investment vehicles and re-stating the ownership rules which exclude trusts with concentrated ownership. Having said that, some of the new tests are still more than a little arcane. The evidence is that it now takes nine pages of tax legislation to define the relevant kind of trust to be labelled a MIT.[139]

The importance of the MIT definition to the funds management industry and the property industry is obvious. It is the key to attracting and expanding their local and foreign client base and to ensuring effectiveness for foreign resident

[139] *Tax Laws Amendment (2010 Measures No 3) Act 2010* (Cth).

investors of the other trust reform projects. This is why the MIT definition has been a constant battleground since 2007.

4 *The Attribution Regime*

The funds management industry and the property industry continues to be significant to the new attribution regime.

In May 2010, the full report of the Board into the taxation of MITs was released by the Assistant Treasurer, together with the government's response.[140] The main recommendation was the so-called elective 'attribution' model for taxing investors in qualifying MITs, instead of relying on the notion of 'present entitlement' found in current law. Under this system, investors would be taxed only on the taxable income that the trustee 'attributes' to them in accordance with their entitlements under the trust's constituent documents. This regime added to the attractiveness of being a MIT, and consequently the pressure for the definition to be expanded.

The Board's report suggested that the new regime for MITs would be limited to trusts which were widely held, engaged primarily in passive investment activities and with clearly defined investor rights — that is, not discretionary rights. A new definition would now dictate which trusts were eligible to elect to treat gains and losses on the disposals of eligible assets as capital gain or loss. Further, the transparency paradigm would be legislated to entrench the principle that the character and source of income was retained unaffected as it flowed through a trust.

The Assistant Treasurer announced that the government accepted almost all the Board's recommendations and would create a new tax system for MITs commencing on 1 July 2011.[141] The government would undertake further consultation on the details of the new regime and on the recommendations about which it had yet to make commitments.

The new attribution regime was due to start in 1 July 2011, then 1 July 2012, then 1 July 2013, and will not now commence until 1 July 2014. While it might seem that this delay is a setback for the industry, the delay is in part due to the preference of the industry to 'wait and get it right.'

C *Using Tax Measures to Promote Australian Industry*

Government is not always the unwilling recipient of industry lobbying. Indeed governments are often willing collaborators in efforts to promote particular industries or sectors of the economy, and the desire of succeeding governments to 'pick winners' has played a part in the trust tax reforms of the last 6 years. In this case, the winner in question is the funds management industry. It is evident from the events outlined already that the funds management industry has had a high

---

140 Board of Taxation, above n 120; Sherry, above n 129.

141 The commencement date was then deferred to 1 July 2012. See Shorten, above n 18.

profile with Australian governments for some time. It has convinced both sides of politics of its significance to the national economy and the government has taken on board many tax measures tailored to fostering this industry's well-being. This part of the paper considers the effects of the decision, maintained over several governments, to develop the Australian funds managements industry through favourable adjustments to the tax rules for inbound investment.

Inbound international tax policy typically examines how to adjust local tax rules to attract more foreign capital so that resident businesses can have access to a larger pool of funds to finance their projects. But there is a curious second strand to Australia's recent inbound tax policy that has influenced the trust tax reform projects. Australia's inbound international tax policy is as much about how to induce foreigners to use the services of the Australian funds management industry. This strand of tax policy is about amending existing tax law to induce foreign retail investment funds, pension funds, insurance companies, sovereign wealth funds and other financial institutions to deliver a sizeable parcel of funds to an Australian resident who will manage it on their behalf (regardless of whether those funds will be invested in Australian enterprises needing further capital). This section of the paper is about tax changes made to effect industry policy.

Since the funds management industry operates almost exclusively through trusts, it has concentrated in its engagement with the government on changing Australia's tax laws with respect to resident trusts. That is, in order for local fund managers to be attractive to local and foreign customers, the industry invested time and effort toward ensuring that the tax system is not undermining their efforts. It is not surprising that the funds management industry played a large part in the trust reform projects just discussed or that the principal effect of those reforms was to reduce the Australian tax on portfolio investments made by the non-resident clients of Australian funds.

1 *The Prolonged Case for Industry-Specific Tax Measures*

As early as the late 1990s, the policy statement of the Howard government, *Investing for Growth — the Howard Government's Plan for Australian Industry*[142] contained a range of industry measures, one of which focussed on this theme of, 'making Australia a more attractive regional financial centre and to building on our existing advantages to ensure Australia's full participation in the increasing global trade in financial services.'[143] The measures in the statement which would foster this policy were largely tax-related because 'major taxation reforms will complement further financial market developments'.[144] The measures proposed involved widening the exemptions from interest withholding tax for interest paid to

[142] John Howard, Prime Minister, *Investing for Growth — the Howard Government's Plan for Australian Industry* (Department of Science, Industry and Training, 1997). The proposed measures were a response to the report of the Review of Business Programs, known as the 'Mortimer Report'. Australia, *Going for Growth — Business Programs for Investment, Innovation and Export* (Department of Science, Industry and Training, 1997).

[143] Peter Costello, Treasurer, *Investing for Growth — Australia, a Regional Financial Centre* (Statement, 8 December 1997) <http://www.treasury.gov.au/documents/185/PDF/Full.pdf>.

[144] Ibid.

non-residents, removing the potential application of the FIF rules to portfolio investments in the United States and broadening access and the concessions attached to the (then rather moribund) Offshore Banking Unit measure.[145] Further support for the funds management industry was again displayed in the May 1999 budget when the Prime Minister announced further measures to promote Australia as a 'centre for global financial services' by creating a separate function, the International Financial Centre Task Force, within the Treasury.

The major tax reform project of the period, the Review of Business Tax (the Ralph Committee), did not focus on international tax issues, but it was no surprise when the Review of International Tax Arrangements project conducted by the Board to complete the unfinished international tax agenda, revisited the position of the finance industry as part of its review.[146] The Board's Report to the Treasurer in 2003 put the case that:

> Australia is a highly attractive location within the Asia Pacific region for financial service providers. We have a large pool of highly talented labour. We also have a maturing funds management industry which helps generate clustering of other high-end service activities — for example, business and professional services, and IT.[147]

Fostering this industry would bring spill-over benefits:

> Australia's strong funds management industry offers a platform to develop a truly global financial services sector in Australia, and thereby attract other financial service companies wishing to locate their regional operations in Australia. In turn this promotes clustering of other high end service activities, such as business and professional services, telecommunications and information technology.[148]

The final report largely adopted the suggestions in the earlier *Consultation Paper* that the FIF, deemed present entitlement and CGT rules needed to be significantly adjusted.

Even though the prominence of the finance industry had been raised by the Howard government, the idea of making Australia a financial hub in the Asia-Pacific became a dominant motif if the ALP's campaign for the 2007 election,[149] and this support continued once the ALP gained government. Trust tax reform remained a key part of supporting this industry.

---

145 These measures were enacted in *Taxation Laws Amendment Act (No 2) 1999* (Cth) sch 1.

146 Treasury, Review of International Taxation Arrangements' (Consultation Paper, Treasury August 2002) ch 4, 'Promoting Australia as a Global Financial Services Centre'. Again, the main targets for change were the FIF rules, the CGT treatment of non-residents investing into Australian trusts, and reforming the tax treatment of resident beneficiaries of foreign trusts, especially the deemed present entitlement rules and transferor trust rules. These are discussed in more detail below.

147 Board of Taxation, *International Taxation — A Report to the Treasurer* (Board of Taxation, 2003) vol 1, 12.

148 Ibid 35.

149 See, eg, Swan, above n 90; Bowen, above n 92.

Further impetus for trust tax reforms came from the Australian Financial Centre Forum ('AFCF'), established by the Rudd government in 2008.[150] As with previous endeavours, the AFCF continued to devote much attention to the various tax as well as regulatory issues. One special focus was adjusting Australian tax law for the benefit of foreign collective investment vehicles which might wish to make portfolio investments in or through Australia.[151]

The same themes re-appeared in the Report of the Review of Australia's Future Tax System ('*Henry Review*') in 2010. They warranted no comment or critique; they were now orthodoxy; all that was needed was a discussion on how to implement them.[152]

2 *Incorporating Industry Concerns in Trust Measures*

The industry had apparently made its case and the government set about amending trust tax law to address industry concerns. The distinct influence of the funds management industry on government policy would be seen in a range of measures, some general and some very specific.

For example, the Assistant Treasurer specifically linked reforms to relax some of the activity restrictions in *ITAA 1936* div 6C to the Rudd government's election commitment to make Australia 'a funds management hub in the Asia-Pacific region'[153] although the principal beneficiary of these measures would be the property industry. The 2010 amendments, which ensured gains on sales of assets held by MITs would be capital in nature, was much more important and beneficial to this industry because of the advantages it conferred for local and foreign investors in Australian managed funds.

A more striking example of this industry's particular position with the government came in the battles over the definition of 'managed investment trust.' As was noted above, the notion of a managed investment trust requires, in general

---

[150] Chris Bowen, Assistant Treasurer, 'Appointment of the Chair and Panel of Experts to Lead the Government Initiative to Position Australia as a Leading Financial Services Centre in the Asia-Pacific Region' (Press Release, No 81/2008, 26 September 2008) <http://www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2008/081.htm&pageID=003&min=ceb&Year=&DocType=>.

[151] Australian Financial Centre Forum, *Australia as a Financial Services Hub — Background Paper* (Treasury, 2008) 8.

[152] Australia's Future Tax System Review, *Final Report* (Treasury, 2010) 182: '[T]he existing tax treatment of managed funds and related entities should be improved to provide greater certainty and minimise the risk of conduit income being taxed. As reforms will raise complex and technical issues, the details of these reforms require separate consideration'.

[153] Chris Bowen, Assistant Treasurer, 'Australia as a Financial Services Hub — Government Introduces Amendments to Reform Division 6C' (Press Release, No 80/2008, 25 September 2008) <http://www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2008/080.htm&pageID=003&min=ceb&Year=&DocType=>. See also Tim Webster, Interview with Chris Bowen, Assistant Treasurer (Radio interview, 2 July 2008) <http://www.treasurer.gov.au/DisplayDocs.aspx?doc=transcripts/2008/030.htm&pageID=004&min=ceb&Year=&DocType=2>. An extensive list of references quoting statements by ministers and ALP officials to this effect appears in Mallesons Stephen Jaques, Submission to the Treasury, *Unsolicited — Amendments to Make Australia's Tax System More Internationally Competitive for Foreign Investment Funds, December 2008,* Appendix 6 <http://www.taxboard.gov.au/content/reviews_and_consultations/collective_investment_vehicles/submissions/Mallesons_Stephen_Jaques.pdf>.

terms, that the trust be a resident, be externally-managed, be widely-held and invest a common pool of funds for all investors. However, from the very outset, the definition of MIT included a further requirement that the fund be 'operated by a financial services licensee ... whose licence covers operating such a managed investment scheme.'[154] In short, only a fund that was managed by an entity that had gone to the trouble of acquiring an Australian financial services licence would suffice. In effect, that requirement confined the benefit of the MIT rate to resident trusts that were willing to pay for the services of an Australian fund manager.

The 2010 revisions to the definition of 'MIT' strengthened this insistence on using local fund managers. That outcome came about in different ways because the new MIT definition created separate rules for retail and wholesale trusts.

For retail trusts, the former reference to holding an Australian financial services licence was removed from the text but its effect remained in place. The new rules required a retail trust to be registered under the *Corporations Act* — not merely to meet the MIS definition — and this registration requirement triggers a requirement that the MIT be managed by the holder of an Australian licence.[155] Similarly, a wholesale trust which voluntarily decided to be registered triggered the same requirement to be managed by an Australian licensee.[156] For wholesale trusts which were not registered, the requirement remained that the fund was managed by the holder of an Australian financial services licence.[157]

But the 2010 amendments added a further restriction which all trusts would need to satisfy:[158]

> (c) a substantial proportion of the investment management activities carried out in relation to the trust in respect of all of the following assets of the trust are carried out in Australia throughout the income year:
>
> (i) assets that are situated in Australia at any time in the income year;
>
> (ii) assets that are taxable Australian property at any time in the income year;
>
> (iii) assets that are shares, units or interests listed for quotation in the official list of an approved stock exchange in Australia at any time in the income year ...[159]

In other words, foreign financial institutions, investors, pension funds and so on would have to employ resident managers to perform the funds management activities if the fund were to enjoy the 7.5 per cent MIT withholding tax rate.[160]

---

154 *Taxation Administration Act, 1953* (Cth) sch 1 s 12-400, as it stood prior to the enactment of *Tax Laws Amendment (2010 Measures No 3) Act 2010* (Cth).

155 *Taxation Administration Act 1953* (Cth) sch 1 s 12-400(1)(f)(ii).

156 Ibid s 12-400(1)(f)(i).

157 Ibid ss 12-400(1)(h), 12-403. Some limited exceptions were available for wholesale trusts.

158 *Tax Laws Amendment (2010 Measures No 3) Act 2010* (Cth).

159 *Taxation Administration Act 1953* (Cth) sch 1 s 12-400(1)(c).

160 This Australian management requirement was not, however, a condition of a MIT being able to elect CGT treatment. See *ITAA 1997* s 275-10.

3 *The Bespoke Tax Regime*

These measures were not the end of the story. The government then decided it was necessary to enact a specific tax regime intended to benefit foreign financial institutions which were, or were to be, the clients of Australian fund managers.

On 15 January 2010, the government released the final report of the AFCF (‘*Johnson Report*’)[161] on how to give effect to the push for enhancing Australia’s standing as a regional financial centre.[162] One of the key recommendations was for a dedicated investment manager regime (‘IMR’), the principal focus of which would be the Australian tax issues arising for non-residents using the services of Australian resident fund managers:

> The Forum recommends the introduction of an Investment Manager Regime (IMR), based on the following principles …
>
> For non-resident investors using an independent resident investment adviser, fund manager, broker, exchange or agent:
>
> - investments in all foreign assets would be exempt from any tax liabilities in Australia;
> - investments in Australian assets would for tax purposes be treated the same as if the investments were made directly by the non-resident without the use of any Australian intermediary …
>
> The location of central management and control in Australia of entities that are part of the regime will not of itself give rise to Australian tax residency of those entities.[163]

The government responded to the report on 11 May 2010 as part of the May Budget and the Assistant Treasurer gave two tasks to the Board: a specific report on the IMR proposal, and a larger project on the range of CIVs and appropriate methods of taxation.[164] The Board’s report on the IMR proposal was delivered to the government in August 2011.[165] It dealt with the means of delivering the IMR regime (an ‘exemption-style IMR’), the features of the foreign investment collective vehicles that would qualify for it, the kinds of activities that might disqualify the foreign fund, and the range of Australian income that would be

---

161 Australian Financial Centre Forum, *Australia as a Financial Centre — Building on Our Strengths* (2009).

162 Bill Shorten, Minister for Financial Services and Superannuation, ‘Investment Manager Regime’ (Press Release, No 10/2011, 19 January 2011) <http://www.dpm.gov.au/DisplayDocs.aspx?doc=pressreleases/2011/010.htm&pageID=003&min=brs&Year=&DocType=0>.

163 Australian Financial Centre Forum, above n 161, 117.

164 Chris Bowen, Minister for Financial Services, Superannuation and Corporate Law, ‘Government Responds to Australia as a Financial Services Centre Report’ (Press Release, No 50/2010, 11 May 2010) <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2010/050.htm&pageID=003&min=ceba&Year=&DocType=>.

165 Board of Taxation, *Review of an Investment Manager Regime as it Relates to Foreign Managed Funds — A Report to the Assistant Treasurer* (2011) <http://www.taxboard.gov.au/content/Content.aspx?doc=reviews_and_consultations/collective_investment_vehicles/report/default.htm>.

exempt. The government accepted most of the recommendations, reserving its position on a handful.[166]

The purpose of the IMR rules was to ensure that non-resident financial institutions which chose to use Australian fund managers would not face further tax in Australia on income and gains made from holding local and foreign assets. The underlying logic is akin to the conduit income rules for resident companies, which attempt to ensure no additional Australian income or withholding tax is triggered on the foreign income derived by resident companies ultimately owned by non-resident shareholders.[167]

In order to bring about this state, it was thought that a series of amendments would be necessary because a series of impediments existed.

One important piece of the puzzle had been solved in 2006 with the enactment of *ITAA 1997* div 855.[168] This ensured, as a matter of domestic law, that Australia claimed CGT from non-resident investors only in respect of an asset that was 'taxable Australian property'.[169] There are few such assets. Importantly, portfolio shareholdings in Australian companies would not be 'taxable Australian property.' This meant that non-residents could invest in Australian equity funds with less concern about facing Australian tax on trading gains. Interest and dividends received from the fund would still be potentially liable to withholding tax, but (capital) gains on sales and redemptions would not.

A second piece of the puzzle had been added in March 2010 with the rules which characterise gains and losses made by MITs on many asset classes as being on capital account.[170] By insisting that the profit made on realisation of an MIT's asset would be regarded as capital in nature, the limited expanse of Australia's domestic CGT rules was invoked. It buttressed the position gains and losses made on most equity interests in companies would be immune from Australian tax.

Unhappily, however, for bond funds, these two provisions did not suffice. First, trading and redemption gains are not dealt with by the CGT rules; instead dedicated provisions ensure that they will typically be regarded as statutory income.[171] Similarly, when the MIT rules were enacted, a decision had been made not to extend capital gain and loss treatment to debt interests held by MITs (a position consistent with the treatment of superannuation funds). This means that Australia's jurisdiction to tax non-residents on profits made by trustees from bond trading and similar transactions remains unaffected and further rules would be required.

So, more needed to be done and Treasury released a consultation paper outlining some of the design options for the regime in May 2010.[172] An Exposure

---

[166] Shorten, above n 28.

[167] Andrew Mills, 'MITs, CIVs, IMR and other TLAs' (2011) 14 *Tax Specialist* 252.

[168] Inserted by *Tax Laws Amendment (2006 Measures No 4) Act 2006* (Cth).

[169] *ITAA 1997* s 855-10.

[170] *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (Cth) sch 3.

[171] *ITAA 1936* s 26BB; *ITAA 1997* div 230 (taxation of financial arrangements).

[172] Treasury, *Developing an Investment Manager Regime: Improving Conduit Income Arrangements for Managed Funds* (Consultation Paper, Treasury, May 2010) <http://archive.treasury.gov.au/documents/1806/PDF/Consultation_Paper_IMR_conduit_income.pdf>. The press release

Draft of the proposed amendments was released in August 2011[173] and a further Exposure Draft in March 2012.[174] Legislation to give effect to the first part of the problem was introduced into Parliament in June 2012 and passed in August 2012.[175]

As was noted above, this part of the IMR has two dimensions — one intended to throw a blanket over the past, and the second to set up the model for the future. The problem which requires a solution is how to ensure no additional Australian income tax is triggered where a foreign fund happens to use onshore management. The problem is really that of unwittingly enlivening residence-based tax claims. It has a number of dimensions.

First, by using a resident manager, a non-resident can find that it has a 'permanent establishment' ('PE') in Australia.[176] This means that gains on all the assets that are connected with that PE — presumably the portfolio of assets being managed in Australia — are now potentially liable to Australian tax. The result comes about this way: a non-resident is liable to Australian CGT only if the asset is 'taxable Australian property'.[177] Shares in an Australian company will ordinarily not be 'taxable Australian property' unless the company is land rich.[178] However, the shares will be 'taxable Australian property' if they have been 'used at any time in carrying on a business through a permanent establishment … in Australia.'[179] The concern is that gains made on selling assets that would not be taxable Australian property if held directly (for example, shares in a non-land-rich Australian company) would now become taxable Australian property because they are effectively connected to an Australian PE.

---

also announced that the government would introduce amendments to Australia's income tax laws to prevent the ATO from raising assessments or amending existing assessments for certain foreign managed funds operating in Australia where the fund might have had some exposure to Australian tax under existing tax law — the FIN 48 issue mentioned above: See above n 23.

[173] Bill Shorten, Minister for Financial Services and Superannuation, 'Next Step in Investment Manager Regime Legislation for Consultation (Press Release, No 121/2011, 16 August 2011) <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2011/121.htm&pageID=003&min=brs&Year=&DocType>. See also Exposure Draft Bill 2011: Exemption for Certain Income Attributable to a Permanent Establishment <http://www.treasury.gov.au/~/media/Treasury/Consultations%20and%20Reviews/2011/Investment%20Manager%20Regime%20Amendments/Key%20Documents/PDF/Exposure_Draft_IMRA.ashx> and accompanying Explanatory Memorandum.

[174] Bill Shorten, Minister for Financial Services and Superannuation, 'Government Releases Second Exposure Draft of Investment Manager Regime Legislation for Public Consultation' (Press Release, No 12/2012, 7 March 2012) <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2012/012.htm&pageID=003&min=brs&Year=&DocType=>. See also Exposure Draft Bill 2012: Tax Laws Amendment (2012 Measures No 4) Bill 2012 <http://www.treasury.gov.au/~/media/Treasury/Consultations%20and%20Reviews/2012/Investor%20Manager%20Regime%20elements%201%20and%202/Key%20documents/PDF/Permanent_establishment_measure_Exposure_Draft_2012.ashx>.

[175] *Tax Laws Amendment (Investment Manager Regime) Act 2012* (Cth).

[176] *ITAA 1936* s 23AH(15) defines a 'permanent establishment' in two ways, by reference either to the terms of a relevant double tax treaty or by using the definition in *ITAA 1936* s 6(1). In either case, the issue is that the resident agent may be endowed with sufficient powers to constitute 'an agent who [has], or [habitually exercises] a general authority to negotiate and conclude contracts on behalf of the [non-resident fund operator]'.

[177] *ITAA 1997* s 855-10.

[178] Ibid s 855-15 item 2.

[179] Ibid item 3.

The second aspect of the problem is similar. If the Australian resident fund manager administers a portfolio of foreign assets, again the use of the Australian resident manager may expose the foreign fund to Australian tax on the basis that those foreign assets are now used in carrying on business through the)PE in Australia. So not only might the non-resident have a branch; that branch might include the offshore assets as well as the Australian assets.

Third, at the extreme, the foreign fund may become a 'resident' under Australian tax laws if the management of the fund is effectively based in Australia. Where the foreign fund is established in a form that Australia would regard as a 'company,' even if that company is incorporated outside Australia, the activities of the resident managers may mean that the foreign entity becomes a resident because it 'carries on business in Australia, and has … its central management and control in Australia.'[180] Where the foreign fund is established in a form that Australia would regard as a trust, the activities of the resident managers may mean that the foreign entity becomes a resident simply on the basis that 'the central management and control of the trust estate was in Australia at any time during the year of income.'[181]

The legislation to alleviate the ongoing problem inserts dedicated provisions, *ITAA 1997* div 842-I, in the legislation with the stated intention of ensuring that:

> foreign funds are not subject to Australian income tax in respect of certain financial arrangements solely because they engage the services of an Australian based agent, manager or service provider; and … the benefits of the tax concessions in this Subdivision are only available where foreign funds are widely held and are not owned by a small group of investors.[182]

The retrospective part of the problem is addressed by amendments to the *Income Tax (Transitional Provisions) Act 1997* (Cth).

The funds management industry has so far convinced the government of the merits of its case but the third part of the IMR package, announced in December 2011, suggests that the industry support is about to stop. The next stage in the IMR project is directed to the situation of foreign funds with foreign, not Australian, management.[183] The exemption would apply whether or not the foreign fund uses the services of a resident fund manager: the Board's recommendation was that the exemption from Australian tax should not depend on a 'managed in Australia' requirement.

It is intended to eliminate Australian tax on Australian-source gains, presumably of a revenue nature, made from dealings with portfolio interests in Australian companies and from financial arrangements. The Board's report recommended that the foreign fund should be exempt from Australian (income) tax with respect to:

---

180 *ITAA 1936* s 6(1) (definition of 'resident').
181 *ITAA 1936* s 95(2)(b).
182 *ITAA 1997* s 842-205.
183 Shorten, above n 28.

> the disposal of investments that are of a portfolio nature; a foreign managed fund will have a portfolio investment if it has a less than 10 per cent interest in that investment.[184]

Further the underlying assets would need to appear on 'a prescribed list of eligible investments' which would exclude land, include shares in listed Australian entities regardless of whether the company was land rich, and include interests in unlisted Australian entities only where those entities are not land rich. Income presently subject to withholding tax — that is, dividends, interest, royalties and fund payments from a MIT — would not be affected by the proposal.

The exemption would apply to a non-resident, widely held, managed fund which undertakes passive investment and does not carry on or control a trading business in Australia. Importantly, the proposed changes would be limited to funds domiciled in countries recognised by Australia as engaging in effective exchange of information.[185]

Legislation to give effect to the proposal has not yet been released.

D *Changes in Tax Policy*

It will be evident that, so far, a desire to implement sound tax policy has not featured as a key driver of any of the trust reform projects. The final portion of the paper examines one project where tax policy considerations and in particular, the changing fashions of cross-border tax policy analysis, have been significant.

In the mid-1980s, Australia began the process of designing and implementing measures against the deferral of income, especially passive income, offshore in non-transparent entities such as companies and blind trusts, and especially where those entities were resident in tax havens. The logic of the measures was driven by the capital export neutrality paradigm; that is, the notion that resident taxpayers should not enjoy a tax benefit from investing offshore rather than onshore.[186]

By the time this process had concluded in the early 1990s, Australia had accumulated four different regimes for dealing with the deferral of income offshore: the Controlled Foreign Company ('CFC') regime which applied where Australian residents held controlling interests in offshore companies;[187] FIF regime where Australian residents held portfolio interests in offshore companies and

---

[184] Board of Taxation, above n 165, recommendation 7.

[185] Ibid.

[186] See, eg, Explanatory Memorandum, Income Tax Assessment Amendment (Foreign Investment) Bill 1992, 1:

> The FSI [Foreign Source Income] measures apply where Australian residents have substantial interests in Controlled Foreign Companies (CFC), or had transferred property to certain foreign trusts for less than full value. They address the tax deferral problem where these entities are used to shelter income from Australian tax by accumulating it in low-tax or tax free jurisdictions. Such income is now taxed as it accrues. The Foreign Investment Funds (FIF) measures will apply to income and gains accumulating in foreign companies that are not Australian controlled or foreign trusts that fall outside the scope of the FSI measures.

[187] *ITAA 1936* pt X.

trusts;[188] a regime (referred to as the Grantor Trust regime) which applied where Australian residents established or contributed to offshore trusts for the benefit of unidentified and unidentifiable beneficiaries;[189] and a regime (referred to as the 'Deemed Present Entitlement' rules) which applied in obscure circumstances where Australian residents held or might hold interests in offshore trusts.[190]

They shared the common goal of attempting to attribute to Australian residents each year certain types of foreign source income being accumulated offshore in opaque entities in which those Australians had some kind of interest. Although they shared a similar target, each had a different scope, pre-conditions, exceptions and outcomes.

In the 20 years since those regimes were enacted they have been subject to much criticism, mostly because of their complexity and alleged over-reaching ambit.[191] Many minor adjustments were made over the years to address some of these criticisms, but the adjustments were always made seriatim and in individual regimes, rather than treating the four as a coherent group targeted at a single problem. The FIF rules, in particular, were adjusted on several occasions with many precise exceptions inserted.[192]

In October 2006, Treasurer Peter Costello announced a review of these four measures.[193] The Board was commissioned by the Treasurer to identify ways in which the complexity and compliance costs of these measures might be reduced, and in particular whether the four regimes could be collapsed into a single regime. The Board was also asked to assess whether the design of the four regimes unduly inhibited the ability of Australian multinational enterprises to compete in the global economy, whether they impeded foreign investment occurring through Australia and their impact on the funds management industry.

In May 2007, the Board released its first discussion paper on the subject.[194] The discussion paper solicited comments on the three principal building blocks used in any CFC or FIF regime: the kinds of interests and offshore entities to which the regime should apply; the kinds of income earned by those entities that should be attributed to the Australian interest holders; and the method for computing the amount of income that should be attributed to the Australian interest

---

188 Ibid pt XI.

189 Ibid pt III div 6AAA.

190 Ibid ss 96A–96C. See generally Lee Burns and Richard Krever, *Interests in Non-Resident Trusts: A Review of the Conflicting Income Tax Regimes* (Australian Tax Research Foundation, 1997); James Momsen, 'Transferor Trusts and Foreign Trusts' (1996) 25 *Australian Tax Review* 64

191 These measures were frequently identified as problems in the reports discussed above about promoting Australia as a regional financial centre. See, eg, Howard, above n 142; Costello, above n 143; Board of Taxation, above n 147; Australian Financial Centre Forum, above n 151.

192 See, eg, *ITAA 1936* pt XI div 8 (exemption for portfolio interests in certain US entities, inserted in 1999); pt XI div 11 (exemption from attribution for short-term visitors to Australia, inserted in 2006); pt XI div 11A (exemption from attribution for resident superannuation entities holding interests in foreign companies and trusts).

193 Costello, above n 12.

194 Board of Taxation, 'Review of the Foreign Source Income Anti-Tax-Deferral Regimes' (Discussion Paper, Board of Taxation, May 2007) <http://www.taxboard.gov.au/content/reviews_and_consultations/anti_tax_deferral_regimes/discussion_paper/downloads/anti_tax_deferral_regime_discussion_paper.pdf>.

holders. The Board received many submissions in response to the discussion paper and held targeted consultation meetings. Those processes continued despite the change of government at the November 2007 election.

On 12 March 2008, the Board released a second document, a position paper, outlining the preliminary conclusions it had reached in light of the submissions and consultations during the previous year.[195] According to the Board, 'the Position Paper sets out the Board's considered views on the high level principles that should apply in the future design of the foreign source income attribution rules.' A further five issues papers were released in May 2008.[196]

The Board's final report on this project was submitted to the government in September 2008 and was released for public scrutiny in May 2009 as part of the 2009–10 Budget papers.[197] The announcement accompanying the May 2009 Budget proposed a number of reforms. First, the CFC provisions would be retained and made the principal rules to prevent the deferral of Australian tax on foreign passive income. However, some foreign trusts and other entities would now be treated as CFCs. Various amendments would be made to the scope and operation of the CFC rules. In particular, there would be changes to the classification of various types of income as active or passive, and to eliminate the automatic attribution of base company income — that is, income derived by a CFC from certain dealings in goods and services with Australian residents. The range of exemptions from attribution under the revised CFC rules would be extended, to include a specific exemption for complying superannuation entities. The calculation of the amount of attributable income from a CFC would be made more flexible — taxpayers could choose whether to undertake the full re-calculation of the CFC's income using Australian tax law, or to use the additional methodologies currently available under the FIF rules; that is, either by measuring changes in the market value of interests in the foreign entity or by assuming a deemed rate of return on the amount invested in the foreign entity.

Second, the FIF provisions would be repealed and possibly be replaced with 'a specific, narrowly defined anti avoidance rule that applies to offshore accumulation or roll up funds'.[198] However, this new rule would be 'carefully monitored'.

---

[195] Board of Taxation, 'Review of the Foreign Source Income Anti-Tax-Deferral Regimes' (Position Paper, Board of Taxation, January 2008) <http://www.taxboard.gov.au/content/reviews_and_consultations/anti_tax_deferral_regimes/position_paper/downloads/anti_tax_deferral_regime_position_paper.pdf>. The discrepancy in dates occurs because of the delay between the date of submission by the Board to the government and the public release of the report by the government.

[196] Board of Taxation, 'Review of the Foreign Source Income Anti-Tax-Deferral Regimes' (Issues Paper, Board of Taxation, May 2008) <http://www.taxboard.gov.au/content/reviews_and_consultations/anti_tax_deferral_regimes/issues_paper/downloads/anti_tax_deferral_regime_issues_paper.pdf>.

[197] Board of Taxation, *Review of the Foreign Source Income Anti Tax Deferral Regimes — A Report to the Assistant Treasurer and Minister for Competition Policy and Consumer Affairs* (Board of Taxation, September 2008) <http://www.taxboard.gov.au/content/content.aspx?doc=reviews_and_consultations/anti_tax_ deferral_regimes/default.htm&pageid=007>. See also Bowen, above n 125.

[198] Ibid.

Finally, the deemed present entitlement rules would be repealed, but the transferor trust rules would be retained, albeit with amendments limiting their scope.

An exposure draft of the legislation to give effect to some of these measures was released in December 2009[199] and one part of the project was concluded in July 2010 when the Act to repeal the FIF and deemed present entitlement rules received Royal Assent.[200]

The last step in the process — the enactment of an 'anti-roll-up fund' regime to replace the FIF rules — is still, however, a long way from completion.[201] On 28 April 2010, the Assistant Treasurer released an exposure draft of legislation to enact the anti-roll-up fund rule.[202] The regime outlined in the exposure draft had the look and feel of a standard purpose-driven anti-avoidance rule, albeit with some tailoring to reflect design features in the current FIF rules. It would be triggered where a resident holds an interest in a FAF (or foreign life insurance product) at the end of the income year and, having regard to certain matters, it is reasonable to conclude that the investment was made for the sole or dominant purpose of obtaining a 'tax deferral benefit' for the resident or other entity. A fund would only be a FAF if returns on investments of the fund are subject to a low level of risk and the rule would not apply if the fund distributed substantially all of its profits within (or shortly after) the income year. Consistent with the superseded FIF rules, certain complying superannuation entities would be excluded from the regime. Consultation on the exposure draft was due to conclude by May 2010.

The most recent instalment of redrafting the anti-deferral regimes occurred on 17 February 2011 with the release of draft legislation on controlled foreign companies and FAFs.[203] The draft was still very far from complete and there is a further round of consultation on this draft before a final draft is produced.[204]

The design of the replacement for the FIF regime, the FAF regime, clearly changed considerably since the original proposals were released in 2010. The most obvious difference is the decision to replace the purpose-based anti-avoidance approach with more objective tests. A foreign company or a foreign fixed trust will be a FAF if both of two tests are satisfied: first, if the market value of all debt interests held by the entity is 80 per cent or more of the market value of all assets held by the entity, and second, if the entity does not distribute (or, in the case of a

---

199 Nick Sherry, Assistant Treasurer, 'Release of Draft Legislation to Repeal Foreign Investment Fund Rules' (Press Release, No 117/2009, 18 December 2009) <http://www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2009/117.htm&pageID=003&min=njsa&Year=&DocType=>.

200 *Tax Laws Amendment (Foreign Source Income Deferral) Act (No 1) 2010* (Cth). The Act repealed the FIF rules, made a number of consequential changes to address the transition to the new situation and repealed the deemed present entitlement rules. These changes took effect for the 2010–11 income year or for CFCs (holding a FIF interest) for statutory accounting periods ending in the 2010–11 income year.

201 Mark Brabazon, 'Tolerating Deferral: Australia's Proposed Foreign Accumulation Fund Rules' (2010) 39 *Australian Tax Review* 205.

202 Exposure Draft, Tax Laws Amendment (Foreign Source Income Deferral) (No 2) Bill 2010.

203 Exposure Draft, Tax Laws Amendment (Foreign Source Income Deferral) Bill 2011.

204 No start date for the new rules was stated in the draft legislation and it was not even mentioned in the Assistant Treasurer's 30 July 2012 press release which set out the new delayed timetable for finalising the incomplete trust reforms: Bradbury, above n 20.

trust, attribute) within three months of the end of its accounting period 80 per cent or more of its realised or controlled profits and gains.[205]

1 *The Changing Fashions in International Tax Policy*

The FAF rules, and the CFC reforms more generally, display the impact of a different motivation — they are driven by a fundamental challenge to the primacy of the capital export neutrality argument that was so dominant in the 1990s. This is a profound reversal of policy.[206]

This challenge has been brewing for some time and traces of it can be seen in almost all of the reform projects which have touched on Australia's international tax policy settings in the last 20 years. The *Review of Business Taxation* in the late 1990s recommended a number of specific measures to rationalise and streamline the operation of the rules affecting beneficiaries in foreign trusts,[207] but largely deferred a wider review of Australia's entire offshore regime.[208] The *Review* blamed the extent of its existing workload and the complexity of the work that would be needed before significant changes could be made with any confidence for the decision.[209]

It was not surprising when the Treasurer announced on 2 May 2002 that a review of Australia's international taxation arrangements would be undertaken by Treasury and the newly formed Board.[210] The consultation paper for the Review of International Taxation Arrangements ('RITA') project was released in August

---

[205] The reference to controlled profits and gains is intended to deal with cases where there are controlled entities making gains that are not being distributed to the FAF.

[206] See, eg, US Treasury Office of Tax Policy, *Deferral of Income Earned Through Controlled Foreign Corporations: A Policy Study* (Department of the US Treasury, 2000); David Bradford, 'Blueprint for International Tax Reform,' (2000) 26 *Brooklyn Journal of International Law* 1441, 1441: 'the system moves away from the accrual income objective that, in principle, motivates so much of the present tax design'; Mihir Desai and James Hines, 'Evaluating International Tax Reform'(2003) 56 *National Tax Journal* 487; Harry Grubert and Roseanne Altshuler, 'Corporate Taxes in the World Economy: Reforming the Taxation of Cross-Border Income' in John W Diamond and George R Zodrow (eds), *Fundamental Tax Reform: Issues, Choices and Implications* (MIT Press, Cambridge, 2008). Recent economic theory has gone even further arguing that a small open economy should not attempt to tax *local* capital income either. See, eg, Roger Gordon, 'Taxation of Investment and Savings in a World Economy' (1986) 76 *American Economic Review* 1086; Roger Gordon, 'Can Capital Income Taxes Survive in Open Economies?' (1992) 47 *Journal of Finance* 1159.

[207] Review of Business Taxation, above n 27, ch 20. See recommendation 20.8, 'that the deemed present entitlement rules in relation to foreign trusts be removed', and recommendation 20.9, 'that the FIF measures be the only attribution regime for foreign fixed trusts unless there are foreign beneficiaries'.

[208] Ibid 683. Recommendation 23.1 proposed 'that there be a comprehensive review of the foreign source income rules'.

[209] Ibid. The Review's timeframe, the breadth of other business tax proposals has precluded a detailed examination of the foreign source income rules (although the Review has proposed certain changes it considers have the necessary priority). These rules comprise the controlled foreign company (CFC), transferor trust, foreign investment fund (FIF) and related measures. They are complex and require further review before comprehensive recommendations can be made.

[210] Peter Costello, Treasurer, 'Review of the International Tax Arrangements' (Press Release, No 21/2002, 2 May 2002) <http://www.treasurer.gov.au/DisplayDocs.aspx?pageID=&doc=press releases/2002/021.htm&min=phc>.

2002.[211] The focus of the consultation paper was on both inbound and outbound investment. With regard to outbound investment, it noted the implicit problem arising from adopting the capital export neutrality paradigm:

> Greater integration and increased levels of Australian direct investment abroad create challenges for Australian businesses operating in the world economy. Some companies with substantial offshore investments have had to decide, for example, whether they can compete successfully while retaining their head office in Australia and how best to access domestic and global capital markets.[212]

It took seriously the possible abandonment of the capital export neutrality paradigm:

> This paper raises a number of options based around the capital import neutrality benchmark to reduce company level tax on direct investment offshore to improve the competitiveness of Australian companies operating overseas and raising capital internationally.[213]

The Board's final report to the government continued in this vein referring to:

> the general policy that an Australian company's foreign subsidiaries should be subject only to the same tax as their local competitors. Australia does not wish to impose additional tax on active income, regardless of whether the foreign country is a high or low taxing country. This policy is generally referred to as 'capital import neutrality' (CIN), meaning that Australian capital deployed overseas should be subject to the same tax burden as foreign capital.[214]

The abandonment of capital export neutrality as a dominant motif in cross-border tax policy was largely a foregone conclusion by the time of the *Henry Review* in 2010. Its report to the government said almost nothing about the taxation of foreign source income earned by residents. The issue no longer warranted even a cursory examination. Instead, the *Henry Review* focussed almost exclusively on the appropriateness taxing Australian source income earned by non-residents or residents, and on methods of relieving Australian taxation on foreign source income passing through Australia to non-residents.[215] The same orthodoxy was apparent in the *Mirrlees Review* undertaken in the United Kingdom at the same time. It too found it unnecessary to devote time to considering whether to tax the foreign source income of UK companies.[216]

This retreat from the dominance of capital export neutrality and the willingness to allow income earned and taxed offshore to remain immune from attribution to Australian investors under CFC, FIF or deemed present entitlement rules, has been a major driver of this package. This same imperative can be seen in the accumulation of individual measures all intended to reduce Australia's taxation of foreign source income: the decision in 1990 to replace the former foreign tax credit system enacted in 1986 with the exemption rules for non-portfolio dividends

---

211 Treasury, above n 146.
212 Ibid 2.
213 Ibid 8.
214 Board of Taxation, above n 40, 79.
215 Australia's Future Tax System Review, above n 152, 182–4.
216 James Mirrlees et al, *Tax by Design: the Mirrlees Review* (Oxford University Press, 2011) ch 18.

and foreign branch profits,[217] the expansion of those exemptions in 2004, and the decision at the same time to exempt gains made on the sale of shares in foreign subsidiaries conducting active business operations ('the participation exemption') regime,[218] as well as the projects just discussed — winding back the CFC regime and replacing FIFs with the FAF regime.

IV Conclusions

The plethora of trust tax reform proposals is evident to all who watch tax law but their impacts, relationships and the current state of play is confusing even for those who might wish to follow closely. The history recounted in this comment is long and complex; keeping abreast of each change is hard enough; assessing what is driving it and where it may lead is more demanding still.

This comment has suggested five principal drivers which have prompted the many projects described: a conscious decision by the ATO to challenge accepted wisdom about the operation of the trust provisions, the politics of election campaigns and the incentives for political parties to outbid rivals for key constituencies, industry pressure to push back borders, reduce constraints, expand the range of concessionary entities and ultimately increase market share, the irresistible desire for governments to pick winners and support its industry policies using tax measures and, finally, changes to the formerly dominant theories about sound international tax policy. Some of these drivers are manifest in several projects; each is a key force in one.

A further message from this saga is that while the same policy and design issues appear in multiple projects, they are rarely being solved in the same way. The result of this activity to date has been overlap, redundancy and rehearsing old debates.

The possibility of a single, coherent and consistent regime for trusts — or even one regime for public trusts and another for privately held trusts — emerging from this collage of interest groups and cacophony of proposals, is small.

---

217 *Taxation Laws Amendment (Foreign Income) Act 1990* (Cth), which added *ITAA 1936* ss 23AH and 23AJ.

218 *New International Tax Arrangements (Participation Exemption and Other Measures Act) 2004* (Cth), which replaced *ITAA 1936* ss 23AH and 23AJ and added ITAA 1997 div 768-G.