5 June 2020

Michael McCormack
Australian Taxation Office

by email michael.mccormack@ato.gov.au

Dear Mr McCormack

Australian taxation Office (ATO) Decision Impact Statement on Burton v Commissioner of Taxation[1]

The Financial Services Council (**FSC**) welcomes the opportunity to comment on the ATO's Decision Impact Statement (**DIS**) on the *Burton v Commissioner of Taxation* case.

The FSC is a leading peak body which sets mandatory Standards and develops policy for more than 100 member companies in one of Australia's largest industry sectors, financial services.

Our Full Members represent Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advice licensees and licensed trustee companies. Our Supporting Members represent the professional services firms such as ICT, consulting, accounting, legal, recruitment, actuarial and research houses.

The financial services industry is responsible for investing $3 trillion on behalf of more than 15.6 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange, and is the fourth largest pool of managed funds in the world.

Summary recommendations

As detailed in the remainder of this response, the FSC makes the following recommendations.

1. The FSC submits that the tax law relating to the issues considered in the *Burton* case is unclear, particularly as it relates to trusts.
    a. In particular, the FSC submits there is a valid interpretation that the final and ultimate taxpayer should apply any relevant cap on Foreign Income Tax Offsets (**FITOs**), not intermediate, flow-through entities such as Managed Investment Trusts (**MITs**) and Attribution Managed Investment Trusts (**AMITs**).
2. Therefore, the FSC recommends that the ATO should state that MITs and AMITs should be able to continue to use current industry practice of not applying FITO caps on behalf of final investors.
    a. This approach will ensure that investors into MITs and AMITs that are not individuals (eg complying superannuation funds in accumulation phase) are not subject to a tax penalty due to their investments through a MIT or AMIT.
3. Even under this approach, involving full flowthrough of foreign gains and FITOs to final taxpayers, MITs and AMITs will face acute difficulties in tracing and reporting the correct amounts of gains and FITOs to final taxpayers through the Annual Investment Income Report

[1] [2019] FCAFC 141

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(**AIIR**), Attribution MIT Member Annual (**AMMA**) statement and Standard Distribution Statement (**SDS**). The FSC submits that the ATO should acknowledge this difficulty and work with industry and Treasury to address and alleviate this problem.

4. If the ATO takes a view that a change to the current industry practice is required for MITs and AMITs, the FSC submits this view should not apply to income years up to and including the 2019–20 year (so the change should only apply from the 2020–21 year at the earliest).
    a. This reflects the widespread industry approach and the ATO's requirements and guidance relating to the AIIR, AMMA and SDS.
    b. If the interpretation of the *Burton* decision results in overdistributions, the FSC requests the ATO provide guidance that an 'over' of foreign tax credits can be converted to foreign income and carried forward into the year of discovery and any overdistribution should not attract penalties. If this approach opens up the possibility of unitholder challenge, then this issue should be addressed as a priority.
    c. The FSC welcomes the ATO's commitment that it will not devote new compliance resources to the *Burton* issue in the current environment; and requests this commitment extent to Simplified Assurance Reviews.
5. The FSC recommends that the ATO should acknowledge the practical difficulties in this approach, and the overtaxation of investors in many cases, and work with the industry and Treasury to address and alleviate this problem.
6. The FSC submits that the DIS should state that if a capital gain as calculated under Australia's Capital Gains Tax (**CGT**) rules has been subjected to foreign tax (regardless of how the capital gain is calculated in the foreign jurisdiction) the capital gain that is assessable income under the Australian CGT calculation is included in the FITO limit calculation.

Alternative interpretation

The FSC submits the interaction of the FITO rules with regards to trusts and AMITs deriving discounted foreign capital gains is unclear.

In relation to trusts that are not AMITs (ie taxed in accordance with Division 6 of the Income Tax Assessment Act 1936), as the trust is not a taxpayer, only the investors determine offsets for foreign tax against an income tax liability under the FITO regime (refer Section 770-130 of the Income Tax Assessment Act 1997 (**1997 Act**)).

In relation to AMITs, Section 276-265 of the 1997 Act provides that a trustee must work out the trust component of each character assuming the trustee was liable to pay tax and was an Australian resident. Section 115-10 also states that a trust is entitled to a CGT discount.

However, Section 276-80 of the 1997 Act states that for the purposes of working out the effects of the components of a tax offset character the member is treated as having paid or received the amount reflected in the determined member component in the member's own right in the same circumstances as the AMIT received the amount.

The interpretation of this should be that members that are not entitled to the 50% CGT discount (such as companies or complying superannuation funds in the accumulation phase) should be taken to be entitled to the FITO on the basis that they paid the amount in their own right.

That is, the words “reflected” should be read widely (otherwise the word would not have been included and the reference would just have been to the amount in the AMMA statement) and the words “in the same circumstances” should simply refer to the circumstances in which the AMIT paid the foreign tax (ie and not deem the member to be a trust for these purposes).

It seems that the ATO accepts this approach in other guidance.

The ATO website notes the following:[2]

> Trust component of a particular tax offset character
>
> The trustee works out the trust component of a particular **tax offset** character as follows:
>
> Amount of the character derived or received in the income year
>
> **plus**
>
> Total unders less Total overs.

To interpret otherwise, would disadvantage such investors going through AMITs compared -with either investing directly or through non-AMIT trusts.

Summary: The FSC submits that the tax law relating to the issues considered in the *Burton* case is unclear, particularly as it relates to trusts.

- In particular, the FSC submits there is a valid interpretation that the final, ultimate taxpayer should apply any relevant cap on FITOs, not intermediate, flow-through entities such as MITs and AMITs.

Industry practice

The FSC has concerns that the ATO’s view on the application of the *Burton* case differs from the longstanding practice in the funds management industry of full flow through of foreign tax credits paid to unitholders and for the unitholders to determine their own FITO entitlement based on their individual circumstances.

Although it can be argued that the *Burton* case confirms the correct interpretation at law, extreme difficulties and challenges are posed from both a policy and implementation perspective for our industry who offer collective investment vehicles as an alternative to direct investments.

From a **policy perspective**, the requirements to determine the correct FITO entitlement rests with each individual taxpayer. While the trustee of an MIT or AMIT may generally possess details and records of their unitholders, this does not mean that the trustee is able to determine for each investor their individual entitlements to tax offsets and CGT discounts, particularly where the ultimate unitholder or beneficiary and taxpayer is investing through an agent or nominee.

Accordingly, it has not been appropriate or equitable for trustees to assume all foreign sourced income or gains, and in turn the foreign tax credits on such income or gains, are always distributed or attributed to taxpayers who are individuals. To limit those foreign taxes paid on foreign sourced capital gains by

[2] https://www.ato.gov.au/General/Trusts/In-detail/Managed-investment-trusts/Managed-investment-trusts---overview/?page=13

50% would not be correct for any non-individual investors, such as complying superannuation entities and corporates. For these unitholders, it is not clear whether or not the ATO views such a limit as being correct or appropriate at law or policy.

From a **practical implementation perspective**, the ATO's view of the *Burton* case implies that the taxpayer needs to be able to trace every foreign tax paid back to the actual foreign sourced income/gain that they have derived. However, a taxpayer investing through a collective investment vehicle such as an AMIT or MIT will only ever receive net income and gains (i.e. after the application of any relevant losses and expenses) attributed or distributed to them. That has always been the primary focus and concern on the part of the trustee (i.e. determining the net income and taxable income of the fund).

However, the requirement to trace foreign taxes paid back to the source of income is suggesting that the trustee cannot continue to attribute or distribute net income and gains, but rather it should almost provide each and every unitholder their share of gross income, gains, expenses and losses. If this is what the ATO expects trustees to be doing, then it represents a fundamental shift in the role of the trustee. We would submit that the existing data, processes, systems and reporting to both unitholders and the ATO have not been configured this way and will require a major overhaul by the funds management industry which also requires a reasonable amount of lead time and resources to achieve. Furthermore, the historic reporting requirements issued and agreed with the ATO through the AIIR and AMMA and SDS have not imposed this requirement and/or level of granularity.

Based on these two perspectives, our members are very concerned with the potential impact that *Burton* has on the Australian funds management industry. Specifically, we submit that the attractiveness of collective investment vehicles to unitholders has always included the simplification and tax reporting burden lifted from them when investing indirectly. However, it would seem that in order to determine relevant FITO entitlements, there will now be an overwhelming amount of administration on the part of the investor, which would strongly discourage the desire to invest indirectly.

The ATO has expressed a view that FITOs should be reduced taking into account discounted capital gains.

As mentioned, there is administrative complexity calculating potential FITO reductions. There is further complexity requiring these adjustments to be made and disclosed at the fund level and in investor distributions. FITO adjustments at the fund level would then need to be followed by investors being required to further adjust their FITO entitlements, relevant to their own circumstances.

Accordingly, we submit that a preferred approach for FITO reductions in relation to discounted gains is for the fund management industry to make the required additional disclosures (ie not reductions) connecting FITOs to discounted capital gains where applicable. The disclosures would enable investors to adjust the FITOs according to the law applicable to their circumstances.

This approach maintains the consistent treatment of managed funds as flow through vehicles and would not disadvantage specific investor groups nor would it create inequity in the distribution process.

We would be grateful if the ATO could acknowledge that this approach is acceptable.

Recommendation: the FSC recommends that the ATO should state that MITs and AMITs should be able to continue to use current industry practice of not applying FITO caps on behalf of final investors.

- This approach will ensure that investors into MITs and AMITs that are not individuals (eg complying superannuation funds in accumulation phase) are not subject to a tax penalty due to their investments through a MIT or AMIT.

Reporting

As mentioned earlier, the historic reporting requirements issued by the ATO through AMMA,SDS and AIIR have not fully outlined the strict requirements required by the ATO's view of the *Burton case*. For instance, the introduction of the concept of "taxable foreign capital gains" in the AIIR has only been included in recent years and arguably the commentary and guidance on this particular field in the AIIR to date has been somewhat generic and unclear as to how it will be used or applied by the ATO.

More importantly, this field has only been mandated in the AIIR, but not in the AMMA or SDS; nor for that matter in the Tax Returns and AMIT Schedules of MITs and AMITs. Furthermore, one would have thought based on the *Burton case*, that there would be a need to also report the amount of foreign taxes paid in relation to these taxable foreign capital gains. However, there is still no such requirement to date to separately disclose how much of the foreign taxes paid related to taxable foreign capital gains. Even if that requirement were introduced in the next AIIR specification and AMMA and SDS, it is still unclear and we submit almost inappropriate (based on the *Burton case*) to aggregate all those taxable foreign income and capital gains and associated foreign taxes paid together that have been derived from multiple foreign jurisdictions.

As a result, FSC members are uncertain as to how to implement and assist both unitholders and the ATO in determining their correct FITO entitlements. Arguably, trustees almost need to transform themselves into an IDPS provider or a bare trustee or agent in order to provide unitholders details on a gross basis (i.e. income, gains, expenses, losses and foreign taxes paid separately). As noted above, we submit that that represents an entirely different and new taxation and reporting regime for the funds management industry.

Recommendation: Even under the approach involving full flowthrough of foreign gains and FITOs to final taxpayers, MITs and AMITs will face acute difficulties in tracing and reporting the correct amounts of gains and FITOs to final taxpayers through the AIIR, AMMA and SDS. The FSC submits that the ATO should acknowledge this difficulty and work with the industry and Treasury to address and alleviate this problem.

Compliance

Overdistribution

For trustees that have elected into the AMIT regime, the current provisions allow for the trustee upon discovery of an over of foreign tax credits to convert them to foreign income and carry them forward into the year of discovery. Accordingly, there is naturally a remedy for this. However, it would be useful for both our members to understand the ATO's position on whether that is acceptable or not.

FSC members are concerned that an overdistribution could be seen as intentional disregard of law and attract penalties.

The attribution of unders and overs to unitholders needs to be managed to ensure any attribution is on a fair and reasonable basis, and also maintains equity amongst unitholders. In this regard, there is a significant concern that the ATO's retrospective application of *Burton* could result in current unitholders suffering adverse tax consequences if prior years adjustments are attributed to them. This could also open the trustee of the fund to unitholder challenge and give rise to other legal issues such as treating unitholders of the same class fairly and equally.

Compliance activity

It is unclear to FSC members that to the extent there has been an overclaim of FITO, just what the ATO intends to do in terms of rectifying this error. First and foremost, trustees who have flowed through or disclosed all foreign taxes paid should not themselves have an income tax shortfall because they had not claimed the FITO. As mentioned earlier, ordinarily an 'over' in foreign tax credits could be converted to an 'over' in foreign income by an AMIT trustee.

The FSC submits the ATO should consider PSLA 2011/27 and to at least administer the law in this area on a prospective basis only, recognising the longstanding industry practice as a relevant factor outlined in this PSLA.

Therefore, we welcome the ATO's commitment that it will not devote new compliance resources to this issue in the current environment (refer to the letter from John Ford of the ATO to FSC of 1 May). However, we submit that this should be an ongoing commitment for all income years up to and including 2019-20.

Recommendation: If the ATO takes a view that a change to the current industry practice is required for MITs and AMITs, the FSC submits this view should not apply to income years up to and including the 2019-20 year (so the change should only apply from the 2020-21 year at the earliest).

- This reflects the widespread industry approach, and the ATO's requirements and guidance relating to the AIIR, AMMA and SDS.
- If the interpretation of the *Burton* decision results in overdistributions, the FSC requests the ATO provide guidance that an 'over' of foreign tax credits can be converted to foreign income and carried forward into the year of discovery, and any overdistribution should not attract penalties. If this approach opens up the possibility of unitholder challenge, then this issue should be addressed as a priority.

Streamlined Assurance Reviews

We also request that this commitment extend to Simplified Assurance Reviews (**SARs**). We understand that SARs for fund managers may include question or questions about the issues raised by the Burton decision.

This submission explains the difficulties that fund managers would have in applying *Burton* as interpreted by the ATO; and the uncertainty and inconsistency in current approaches making it difficult for fund managers to apply these approaches. These problems similarly create substantial difficulties for funds in completing any SAR questions that relate to the *Burton* decision. Therefore, we request that questions relating to this issue not be included in the SARs.

Recommendation: The FSC welcomes the ATO's commitment that it will not devote new compliance resources to the *Burton* issue in the current environment and requests this commitment extent to Simplified Assurance Reviews.

Incorrect taxation/overtaxation

As noted above, while the *Burton* case provides clarification around the FITO entitlements in respect of amounts subject to discount or deduction prior to their inclusion in assessable income, it is evident that from a policy perspective this leads to incongruous outcomes. This much is acknowledged by the Full Federal Court decision citing comments of Logan J:

> *"The inadequacy in Div 770 may well be in its object, especially when one has regard to broader statements such as that of the OECD as to the object of providing relief from double taxation. Viewed by reference to those broader objectives, it does seem incongruous that a prior year's losses might reduce or even eliminate for foreign tax offset purposes any amount on ("in respect of") which foreign tax has been paid.* ***[para 91 of [2019] FCAFC 141]***

Example

The concern is the legislation does not recognise the different ways in which countries such as the United States of America (**US**) and Australia provide essentially the same concessional treatment for capital gains. In the US, for the most part, tax is paid at a discount rate of 15% (about half the normal tax rate) on the whole gain. However, in Australia, only 50% of the gain is included in the calculation of the net capital gain that is then included in assessable income, which is assessed at the taxpayer's full marginal tax rate.

The example below illustrates the effect of the *Burton* case on the FITO rules is to limit the tax offset to 50% of the US tax paid. The outcome is that the taxpayer's FITO will be lower resulting in their overall Australian and US income tax payable on the sale of the US investments may be up to half again as much than it would be if it was an Australian investment.

Paul is an Australian resident unitholder of an AMIT which sold foreign investment asset held for more than 12 months for a capital gain of $100,000. The tax rate on the long-term capital gain in the foreign country is at half the 40% normal tax rate in the foreign country. Paul is attributed that gain and FITO. For ease of calculation, assume his Australian marginal tax rate is 40% (ignoring Medicare levy).

		Foreign asset (Aus $)	Australian Asset (Aus $)
a.	Attributed foreign country capital gain	100,000	-
b.	Foreign tax paid @20%	**20,000**	-
c.	Australian capital gain	100,000	100,000
d.	Australian discounted capital gain (cx50%)	50,000	50,000
e.	Australian gross tax @40%	20,000	20,000
f.	Less FITO (bx50%)	10,000	-
g.	Australian net tax (e-f)	10,000	**20,000**
	Total foreign and Australian tax (b+g)	**30,000**	**20,000**

In this regard, the FSC's proposal is that Australian taxpayers should be provided with a foreign tax credit for any foreign taxes paid in relation to a transaction against the Australian tax payable on the income or gains. This would address the current incongruities between the operation of Div 770 and the policy objective of eliminating double taxation.

Recommendation: The FSC recommends that the ATO should acknowledge the practical difficulties in this approach, and the overtaxation of investors in many cases, and work with the industry and Treasury to address and alleviate this problem.

Foreign exchange gains and losses

We request further guidance from the ATO on how the *Burton* case applies to foreign exchange gains and losses and suggest that this be addressed in the DIS.

As the FSC noted in our submission on TD 2019/D10 (see **Attachment 1**) and the FSC response to ATO questions on that submission (see **Attachment 2**), we recommend that the TD should make it clear that if a capital gain as calculated under Australia's CGT rules has been subjected to foreign tax (regardless of how the capital gain is calculated in the foreign jurisdiction), the capital gain that is assessable income under the Australian CGT calculation is included in the FITO limit calculation.

That is, we submit that the ATO should make it clear that the words *in respect of* in sub-paragraph 770-75(4)(a)(i) 1997 Act be read generally as referring to all the assessable income arising from a capital gain upon which foreign tax is paid.

If this were not the case, an Australian taxpayer could be subject to double taxation on a foreign capital gain. For example, if an Australian complying superannuation fund in the accumulation phase sells a foreign asset and has a discounted capital gain of $10 the Australian tax would normally be $1.5, but say that if FX movements were removed the foreign capital gain (converted to Australian dollars) is only, say, $5, it is not clear whether the ATO considers that the cap should be calculated on $10 or on $5. If the cap were calculated on only $5 and the capital gain was taxed at, say, the US rates of 21% (or $1.05) then cap would be $0.75 cents and as such the Australian super fund would have suffered worldwide tax of $1.8 (being $0.75 Australian tax and $1.05 US tax, as $0.3 of the foreign tax would not be creditable).

Recommendation: The FSC submits that the DIS should state that if a capital gain as calculated under Australia's CGT rules has been subjected to foreign tax (regardless of how the capital gain is calculated in the foreign jurisdiction) the capital gain that is assessable income under the Australian CGT calculation is included in the FITO limit calculation.

Conclusion

The FSC would welcome the opportunity to discuss any aspect of this submission – please contact the me in the first instance on mpotter@fsc.org.au

Your sincerely

Signed

Michael Potter
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