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TAXATION INSTITUTE of AUSTRALIA
IT'S ESSENTIAL

16 February 2010

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Dear Raphael

Exposure Draft Legislation Extending the Tax File Number Withholding Arrangements to Closely Held Trusts including Family Trusts

The Taxation Institute of Australia **(Taxation Institute)** is pleased to provide comments in relation to the exposure draft Exposure Draft Legislation Extending the Tax File Number Withholding **(TFN Withholding)** Arrangements to Closely Held Trusts including Family Trusts

The Taxation Institute notes that the "mischief" intended to be addressed by the legislation as announced by Senator Sherry is to alleviate issues the Australian Taxation Office **(ATO)** has in matching data between Trust distributions and their beneficiaries.

As a general comment, the Taxation Institute points out that the ATO obtained a significant amount of data concerning distributions from Trusts in the Trustee Beneficiary Statements and schedules for the Company and the Trust's Income Tax Return. Further, if there is any information on the current Trust Income Tax Return that is lacking, the Commissioner of Taxation can amend the disclosure requirements in the income tax return without the need for amending legislation.

Trusts in General

From a review of the legislation, the TFN Withholding obligations follow those obligations that apply to employers and arms' length investment bodies (eg Listed companies and Listed Trusts, financial institutions and managed investment schemes).

The Taxation Institute does not consider that the "model" that applies to these bodies is appropriate or adequate for Closely Held Trusts or Family Trusts. There are several important differences between a Closely Held Trust, a Family Trust, employers and arm's length investment entities.

(i) An employer/employee relationship carries with it a contractual obligation between employer and employee and is an ongoing relationship that exists on a daily basis. An employee knows who their employer is. A beneficiary of a discretionary trust may be unaware that they are a beneficiary of the trust and may not be able identify the trust of which he/she/it is a beneficiary.

(ii) An arms' length widely held investment such as shares in a Public Company or units in a widely held Unit Trust are voluntary investments made consciously by the investor. Further, these "public" bodies have share registries and significantly greater accounting resources available to them at the disposal when compared to a Family Trust or closely held entity. This is in contrast to a beneficiary of a discretionary trust who may not be aware of all the trusts under which they are a beneficiary.

(iii) A closely held entity is often a family type relationship that can extend to third parties such as charities, tax exempt entities, deductible gift recipients, schools and other parties. Charities and tax exempt entities, deductible gift recipients, school building funds and similar bodies are generally a beneficiary of most family discretionary trusts in Australia. Nevertheless, they typically do not have any information concerning which trusts they are a beneficiary of until some time after a distribution is made.

A beneficiary does not generally "voluntarily" choose to be a beneficiary but is made one by the scope of Trust Deed. As such, a beneficiary may not know that they have become beneficiary of the Trust.

For example, an individual (John) could establish the John Family Trust making Members of Parliament beneficiaries of the Trust. If the John Family Trust made a distribution to a Member of Parliament, the Member of Parliament would be unaware of that distribution until the Trustee of the John Family Trust notified the Member of Parliament of their entitlement.

Similarly, members of the same family can be distant and may not have ongoing communications between them from time to time. Nevertheless, as family members, they are typically beneficiaries of the Trust. Consequently, the Taxation Institute does not consider that it is appropriate that the TFN Withholding "model" that applies to arms' length bodies such an employer/employee relationship or a publicly listed investment can be applied in the same manner to a Family Trust or closely held Trust.

The practical implications of that point will become more apparent as we examine specific provisions in the Exposure Draft Legislation. The key point though may be summarised as follows.

TFN withholding would apply under the proposed section 12-175 if a beneficiary did not notify a trustee of their Tax File Number **(TFN)** prior to 30 June (being the time they typically become presently entitled to a distribution. If a beneficiary is unaware that they are a beneficiary of a trust, practically how do they communicate their TFN to a trustee prior to 30 June? Charities, tax exempt entities, deductible gift recipients, school building funds etc are generally a beneficiary of most family discretionary trusts in Australia. Nevertheless, they typically do not have any information concerning which trust they are a beneficiary of until some time after a distribution is made. However, on its face, they would have to notify every discretionary trust in Australia of their TFN to avoid TFN Withholding on their distribution.

Clearly, this is an unintended consequence and not practical. That said, the same dilemma applies to all taxpayers in Australia and not tax exempt entities or charities. The Taxation Institute will elaborate on this point further in the discussion of section 12-175.

Division 4B of the Income Tax Assessment Act 1936

Quotation of Tax File Numbers

The ATO already has details of TFNs included in the various disclosures that are made by Trusts on lodgement of their Tax Return. The Trust Distribution Statement usually contains TFN information of beneficiaries.

The Taxation Institute queries whether it is necessary for these beneficiaries to quote their TFN again to the Trustee on the basis that the ATO been given sufficient notification that that beneficiary is a beneficiary of the Trust and has already quoted their TFN (or otherwise make the trustee aware of their TFN) if it appears on a Trust's Distribution Statement.

The Taxation Institute considers it unnecessary if the ATO already has the information concerning the TFN of beneficiaries of Trusts that have reported those TFN's in their Tax Returns. Do these beneficiaries necessarily have to quote again in an approved form under the proposed Section 202DO?

The Taxation Institute also points out that the ATO is able to notify Tax Agents of which beneficiaries have already quoted their TFN to the Trust on the Tax Agent Portal. Consequently, the ATO would be able to notify the Tax Agent of Trust concerning the current beneficiaries that are already on its data base. The Tax Agent can confirm accuracy of the information electronically in a secure form.

The Taxation Institute also points out that the Division is silent as to whether the TFN must be quoted every year or once and for all. The sensible inference is that once the trustee of the Trust has been notified of the TFN of the beneficiary, it does not need to seek it again. The Taxation Institute recommends legislative confirmation of that position.

Subsection 202DP(2) provides that once the TFN has been reported, the Trustee must give a report to the Commissioner within one month after the end of the quarter in which the TFN was quoted. The provision also provides the Commissioner with the discretion to extend that time.

The Taxation Institute considers this is an instance where the TFN quotation model that applies to "third party" arrangements does not fit well with closely held Trusts and Family Trusts. Typically, a Trustee will resolve prior to 30 June which beneficiaries will be entitled to a distribution of income or capital of the Trust. That distribution is often confirmed post 30 June when Accounts for the Trust are finalised.

A beneficiary will often not be aware that they are presently entitled until some time after year end, ie when the Trustee has actually notified the beneficiary. Consequently, the beneficiary will normally have no reason to provide their TFN to a Trust prior to that. This is in direct contrast to the position of an investor investing in a share or a unit trust. In those cases it is normally the expectation of the investor that at or around the time of actual investment the investor will complete documentation advising the company or the unit trust (as the case may be) of the investor's relevant details including TFN. Likewise, when a person commences employment the person will expect to complete documentation that provides the employer with details of the employee's TFN. There is both knowledge on the part of the taxpayer and a procedure that the taxpayer knows must be completed at that time.

Identity Theft

A person's TFN is a key piece of identification that ought not to be given out without some caution. As a beneficiary may be unaware of their entitlements from a Trust until some time after year end, Section 202DO and Section 202DP appear to require that a beneficiary to identify each possible Trust that exists where they might have some connection with and quote their TFN. The beneficiary is unable to determine whether they have quoted their TFN to the correct trust.

Further, if the beneficiary held a mistaken belief that they are a beneficiary of the Trust, they would be giving their identity away unnecessarily and exposing them to a greater risk of identity theft or fraud.

To take our example earlier concerning a Trust that is established where all the Members of Parliament are beneficiaries, it would be unreasonable to expect each of the Members of Parliament to seek out all such Trusts to quote their TFN in the hope that they might receive a distribution from that Trust.

The Taxation Institute does not consider that the TFN Withholding Model that applies to third parties as being appropriate or workable for a closely held group.

Naturally, closely held groups and close families would be able provide this information in a timely manner. However, if families are not “close” and do not interact for prolonged periods of time, this places an unreasonable burden on the beneficiary to find family related Trusts.

Further, the legislation provides potential “rogues” with a method of obtaining key identifying information from potential beneficiaries. Trusts set up by “rogue” operators could write to all the potential beneficiaries advising them that they are a beneficiary of a Trust citing this legislation support for a request for them to provide their TFN.

A beneficiary, fearful that they may lose out on part of their entitlement because of the withholding obligations imposed by this legislation may quote their TFN to the rogue operator who could use that key identity related information for potentially fraudulent purposes.

In short, this model exposes beneficiaries to potential fraud which the Taxation Institute considers unacceptable. As such, the current system where the TFNs are gathered in the Trust’s Tax Return appears to be the preferred option of dealing with closely held groups rather than considering Family Trusts as akin to third party investments or employer/employee relationships.

Section 12-175 – Payment in respect of Entitlement to Trust when TFN not Quoted

The Taxation Institute notes that under the proposed Section 12-175 of the Tax Administration Act, if a beneficiary becomes presently entitled to a share of income of a Trust, the Trustee is required to withhold if the beneficiary has not quoted their TFN at or before the time they became presently entitled.

This appears to be another instance where the “third party” TFN Withholding Model is not appropriate for closely held Trusts or Family Trusts. Typically, a Trustee will resolve at or before 30 June which beneficiaries are entitled to a share of the income of the Trust based on their understanding of the financial position of a Trust at that time. It may turn out post 30 June, that the Trust does not have any income upon which a beneficiary can be presently entitled. Although the resolution is made prior to 30 June, in practice, full details concerning the entitlement do not become apparent until some time after 30 June.

A beneficiary will typically be unaware that they are presently entitled to any distribution until the final Accounts concerning the Trust are prepared and their entitlement is confirmed. Consequently, a beneficiary may be unable to quote their TFN prior to being notified of their present entitlement by the Trustee. Nevertheless, Section 12-175 would require the Trustee to withhold 46.5% of their entitlement because a beneficiary may be unaware of their entitlement until long after 30 June.

To remove any prospect of TFN Withholding, beneficiaries would have to seek out each Trust they could possibly be a beneficiary of to quote their TFN. Naturally, Trusts that they have already received a distribution from in prior years could be addressed in a reasonable manner. However, if this is the first year the Trust distributes income to that beneficiary, how is the beneficiary practically going to quote their Tax File Number prior to being notified of their entitlement from the Trust?

The Taxation Institute recommends that the “entitlement time” ought to be redefined. The Trustee ought to have reasonable time to notify the beneficiary of their entitlement and upon receiving that notification, the beneficiary should have at least 30 days to quote their TFN. As a matter of practice, this would occur at or around the time the Trust is due to lodge its Tax Return. Once quoted, the Trust should not have to seek out the TFN of that beneficiary in respect of future years.

Otherwise, the provision places an unreasonable burden on the Trust, the Trust’s Tax Agent, Advisors and the beneficiaries to complete the financial accounts prior to 30 June so that a beneficiary could be notified prior to their entitlement that they might receive a distribution in the future.

Further, the Taxation Institute would like to reinforce the point of a rogue seeking to obtain key identity information writing to potential beneficiaries stating that if they don't quote their TFN by a particular date they may lose 46.5% of their entitlement from the Trust. We consider that the legislation should protect "innocent" beneficiaries from such rogues rather than promoting an environment for potential fraud.

Section 12-175 – Payment in respect of Entitlement to Trust when TFN not Quoted – an alternative approach

If this draconian approach is going to be implemented, then consideration should be given to the obligation to withhold being imposed on the trustee at the time the trustee actually makes physical payment to the beneficiary. This would permit the trustee to communicate with the beneficiary obtain details of the TFN and communicate that information to the ATO.

Subsection 12-175(4)

The Taxation Institute considers this provision requires further specific comment. Subsection12-175(4) requires a Trustee to withhold if a beneficiary that is "deemed" to be presently entitled under subsection 95A(2) or Section 101. A failure to withhold attracts penalty of 20 penalty units.

Often, deemed present entitlements under subsection 95A(2) or Section 101 will not become apparent until some time after 30 June and upon audit activity of the ATO. Indeed, a Trustee and beneficiary may be completely unaware that either of the provisions can apply as they are technically complex and difficult provisions to apply. Further, both are open to interpretation. A Trustee may have a reasonably arguable view or position as to why neither of those provisions apply. Nevertheless, failing to comply with subsection 12-175(4) is an offence of strict liability.

Hence, the Trustee will be deemed to have breached the provision even though they may have a reasonably arguable view as to why subsection 95A(2) or Section 101 does not apply. That reasonably arguable view may subsequently be overturned by a decision of the Tribunal or Court but could still be reasonably held.

The Taxation Institute submits that the TFN withholding in the circumstances prescribed by subsection 12-175(4) is not appropriate except where there is a determination by the Tribunal or Court. Alternatively, if a Trustee has a reasonable belief that the provisions do not apply, the TFN withholding should not arise at all.

The Taxation Institute recommends that either subsection 12-175(4) should be significantly modified in the manner suggested or removed altogether from the final legislation.

Section 16-75 and Section 16-153 of the Exposure Draft

The Taxation Institute is very concerned about the operation of both of these provisions. The Taxation Institute considers that, as drafted, the provisions impose an unreasonable burden on the Trustee, the Trust and their Tax Agents. Further, the Taxation Institute considers that this is another instance where the "third party" TFN Withholding Model that applies to an employer/employee relationship or an arms' length publicly listed investment is not appropriate for closely held Trusts and Family Trusts.

Under Section 16-75, a Trustee must pay the Commissioner the amount of the TFN withholding by the end of the 28th day of the next month following the time the Trust must provide the TFN report to the Commissioner under Section 16-153. Section 16-75 grants the Commissioner a discretion to extend the period of time to withhold.

Under Section16-153, irrespective of whether the beneficiary has quoted their TFN or not, the Trustee must provide a report to the Commissioner of Taxation within two months of the end of the income year (ie by 31 August for a 30 June balancing Trust) outlining all the beneficiaries that are presently entitled to a share of the income of the Trust. Section 16-153 provides the Commissioner with a discretion to extend the time to provide a report.

In short then the Trustee of a 30 June balancing Trust has the following obligations:

(i) By 31 August they must provide a report to the Commissioner of all the beneficiaries that have a present entitlement to a share of the income; and

(ii) By 28 September pay to the Commissioner the amounts of TFN Withholding.

The Taxation Institute reinforces its comments concerning the timing upon which the TFN must be provided. In practice, if a beneficiary is unaware of their entitlement they will be unable to provide that TFN to a Trust by 30 June. Further, the Trustee is probably uncertain of the exact amount that that beneficiary is presently entitled until the final accounts are prepared. As such, the Trustee will be unaware of the correct TFN Withholding by 28 September, especially since the Trust typically does not have to file a Tax Return until May of the following year.

Notwithstanding, the Trustee must notify the Commissioner of all the beneficiaries that are potentially presently entitled to an amount by 31 August. This represents a significant acceleration of the reporting obligations of a Trust when compared to the current position under the ATO's Tax Agent Lodgement Program of being May of the following year. The Taxation Institute's expectation is the Commissioner will exercise his discretion to extend the time that this report must be provided to the time the Tax Return for the Trust is lodged. However, the legislation or the Explanatory Memorandums does not suggest that will occur automatically or otherwise as of right.

If the extension is not granted, then Trusts will have to finalise their financial positions by 31 August. That will place an unreasonable burden on their reporting resources as well as the Tax Agents filing their Tax Returns. Trusts are often one entity within a larger group. Consequently, the entire group's reporting obligations will also be accelerated to 31 August when currently it is some 9 to 11 months after year end.

The Taxation Institute does not consider that there are sufficient Tax Agents with sufficient resources to be able to comply with these obligations for every closely held trust or Family Trust in Australia.

The Taxation Institute recommends that the period of time in which the report ought to be provided to the Commissioner should coincide with the lodgement of the Income Tax Return.

Use of Division 6 as the Trigger for TFN Withholding

The following example is provided to illustrate the difficulty associated with the TFN Withholding Provision being based on Division 6 of the Income Tax Assessment Act 1936. The Taxation Institute points out that the example is loosely based on a matter currently before the High Court of Australia of *Bamford v FCT*.

> Assume the income of the Trust is $100 for the year ended 30 June 2010. The Trust also has derived a significant capital gain of $700,000 for the year ended 30 June 2010.
>
> The John Family Trust resolves to distribute the $100 income to a charity and the $700,000 capital gain to John's wife, Mabel. Neither the charity nor Mabel have quoted their Tax File Numbers to the John Family Trust prior to 30 June 2010.
>
> ***To whom does the TFN Withholding apply and in what amount?***

Under the “proportionate view” as confirmed by the Full Federal Court in FCT v Bamford, the charity is presently entitled to 100% of the income and as such is taxed on 100% of the net income which includes the capital gain. The net income of the Trust is the $100 of income plus the $700,000 capital gain.

Consequently, the Trustee must withhold 46.5% of $700,100 ($700,000 plus $100) when the charity’s entitlement from the Trust is only $100.

In the above example, neither the charity nor Mabel have quoted their TFN and as such, had Mabel been presently entitled to the income as well as capital gain, the same amount of TFN Withholding would apply. However, the TFN Withholding Credit only applies to the charity and not to Mabel when she lodges her Tax Return. How will Mabel obtain a refund of the TFN Credit?

The other extreme is prior to 30 June, Mabel quotes her TFN and the charity does not.

If that occurred, then the Trustee would be bound to withhold 46.5% of $70,100 ($700,000 plus $100) when in fact, Mabel’s entitlement from the Trust should not be subject to any form of TFN Withholding at all.

The Position of Persons who do not have a TFN and do not otherwise require a TFN

There are a large number of beneficiaries who do not currently possess a TFN because they are not required under the current taxation law to lodge a tax return.

Such persons will as a direct result of this measure require them to apply for a TFN and then to prepare (or more likely cause to be prepared) a tax return and lodge that tax return at a time when the apparent policy driver is to remove tax return lodgers that are non-taxable from the tax return system. It will be critical that this aspect is expressly addressed by Government.

Consider the following example:

Sally is an orphan aged 19 studying at university. Her grandparents, with whom she lives, have established a family trust to ensure that she has a small independent income.

Sally does not have a TFN.

The net income of the trust is in the order of $3,000 per annum and the trustees, her grandparents intend to exercise their discretion under the terms of the trust instrument to make Sally presently entitled to all of the net income.

Under the proposed measures, if Sally has not applied for and obtained a TFN by the time that her grandparents exercise their discretion, they will be little to pay over to the ATO approximately half of the $3,000 and it will be up to Sally to obtain a TFN prepare a tax return and lodge it in order to recover the moneys withheld.

Let us hope that Sally is studying taxation at university otherwise the compliance costs will severely disadvantage her.

Method of Quotation of TFN – section 202DO

Given the circumstances, it would be strange if section 202DO were to act as an exhaustive way in which a beneficiary could quote their TFN. This is particularly the case when the timing of the exercise of the discretion to make someone presently entitled is likely to be a meeting of trustees or a meeting of the directors of the trustee company that there should be flexibility in the manner of quoting the TFN rather than requiring it be in a manner approved by the Commissioner. If the beneficiary quotes a TFN to the trustee, eg in response to a question in a phone call, then that should be sufficient for the trustee.

Consider the following example:

> Charles is back packing around South America. The trustee of a family trust intends to exercise the discretion to appoint income to Charles. The trustee does not know the TFN of Charles. The trustee rings Charles and Charles advises his TFN over the phone.
>
> It will take a week for any written confirmation to reach the trustee.
>
> The trustee holds the trustee meeting immediately after the telephone call.

It should be clear from the legislation that this satisfies the requirement. It should not be something where there is a need to search for what the Commissioner considers acceptable. The major means of quoting should be has it been given to the trustee. If it is considered that other methods of delivery should apply then by all means permit the Commissioner to prescribe them – but not the obvious ones which Parliament is quite capable of confirming.

Funding of TFN

The other aspect to the example is that the Trustee is often not required to pay the present entitlement to the beneficiary until some time after 30 June when they have the cash resources. The requirement to pay 46.5% of their present entitlement in tax by 28 September imposes an unreasonable financial burden on the Trust as the decision to dispose of assets and pay the distribution across is now governed by the beneficiary rather than the Trustee.

If the beneficiary deliberately does not quote their TNF, they will, in fact, force the Trustee to sell an asset to pay 46.5% of that entitlement to the ATO. Prior to the introduction of these provisions, no such impost is placed on the Trustee such that they are forced to sell by the time the TFN Withholding is due.

The Taxation Institute's use the above example to highlight how the TFN Withholding Model that applies to third party investments is not appropriate for closely held Trusts. Again, the Taxation Institute's view is that any TFN Withholding obligations should only arise until sometime after the Income Tax Return for the Trust is due for lodgement.

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If you require any further information or assistance in respect of our submission, please contact David Williams on 02 9958 3332 or the Taxation Institute's Tax Counsel, Angie Ananda, on 02 8223 0011.

Yours sincerely

David Williams
President