



THE TAX INSTITUTE

17 September 2012

General Manager
Business Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600
Attn: Mr Tim Beale

By email: fixedtrust@treasury.gov.au

Dear Mr Beale,

A More Workable Approach For Fixed Trusts – Discussion Paper

The Tax Institute is pleased to have the opportunity to make a submission to the Treasury in relation to A More Workable Approach For Fixed Trusts - Discussion Paper (**Discussion Paper**).

In the overall context of trust tax law reform, although it may have been ideal to have examined the concept of “fixed trust” within the context of the Division 6 rewrite, it is nonetheless imperative that the notion of what is a “fixed trust” be simplified so there is greater certainty about when a trust will be regarded as a fixed trust for income tax law purposes. In this regard, we provide our comments to Treasury on the issues raised throughout the Discussion Paper.

Summary

Our submission below addresses the questions raised in the Discussion Paper. In particular, The Tax Institute is of the view that a move towards the adoption of a retrospective test that allows a trust to meet a more certain standard of having “vested and not defeated” interests would broadly be beneficial rather than retaining a test which requires a prospective and uncertain examination of whether a trust is fixed or not.

Nonetheless, we have addressed the Questions in the Discussion Paper even though in some cases the questions are premised on the existing test or on the so-called “clearly defined rights” test.

Discussion

A review of the policy contexts in which the term “fixed trust” is currently being used should be conducted to see if there is a common theme in the way the term is currently being used throughout the income tax legislation. An exercise of this nature would assist to shape the context in which a definition for the term could be devised.

If a common theme cannot be found, this suggests that either the term would need to be defined according to each policy context in which it is being used, or, more importantly, the question asked whether the concept of fixed trust is appropriate to the context. This would raise the question whether in fact it is necessary to define the concept of a “fixed trust” at all for the purposes of the income tax law.

Below we have addressed the questions raised in the Discussion Paper.

Question 1

Is it appropriate for certainty and simplicity to consolidate the definition of ‘fixed trust’ into subsection 995-1(1) of the ITAA 1997?

Question 1 raises the issue whether having a consolidated definition of “fixed trust” contained in section 995-1(1) is appropriate. In our view, the requisite definition of “fixed trust” is to be determined by the context in which it is being applied. The term is used in several different kinds of provisions (as listed in the Attachment to the Discussion Paper) such that the term is being used in different policy contexts. A strict “black letter law” definition of “fixed trust”, for example, may be appropriate in some contexts whereas a definition that relies on the common law definition of the term may be more appropriate in other circumstances.

Where it is determined that there is a common theme regarding the meaning of the term “fixed trust”, having a consolidated definition in section 995-1(1) ITAA 1997 is desirable and prima facie may provide certainty and simplicity. However, the absence of a common theme suggests that it would not be appropriate to have a consolidated definition. Rather, the term would need to be defined for each context in which it is used and a consolidated definition in the income tax would be virtually redundant.

Question 2

Is it appropriate to remove the ‘trust instrument’ requirement from the basic definition of a ‘fixed trust’?

In our view, there is no policy reason for requiring the existence of a trust instrument for the purpose of defining the term “fixed trust”. There are many cases where it will be evident from the operation of the trust whether a beneficiary’s entitlement is fixed or not, for example in the case of a constructive trust, resulting trust or bare trust where ordinarily a written instrument is absent. The terms of the trust in all cases will be sufficient evidence of whether a trust is fixed or non-fixed.

Though there is benefit in encapsulating the terms of the trust in a written instrument, if there is uncertainty as to the terms of a trust, a Court will ultimately be able to determine the terms of the trust for the benefit of the trustee and beneficiaries. In this regard, we do not consider the existence of a trust instrument to be a necessary requirement of the basic definition of a “fixed trust”.

Question 3

Is it appropriate to provide that an entitlement is not to be taken as being defeasible simply because of the existence of certain powers? If so, which powers should not result in an entitlement being treated as defeasible?

The discussion in the Discussion Paper preceding this question focuses on the availability of the Commissioner’s discretion to determine whether a trust is fixed or not by considering the three elements stated at 1.2.1 in the Discussion Paper concerning the circumstances and likelihood of the entitlement not vesting or defeasance happening and the nature of the trust. The discussion then focuses on when an interest is considered to be “vested” and when an interest is capable of defeasance, which broadly comes about from the exercise of a power either contained in the trust instrument or statute which defeats the interest.

As confirmed in the Discussion Paper, the decision in *Colonial First State Investments Limited v Commissioner of Taxation* [2011] FCA 16 drew the conclusion that it is not only where there is a power in the trust instrument or statute an interest can be defeated, but also where such a power could be brought into existence by either the trustee or the beneficiaries. The mere possibility of this occurring is sufficient to make the interest defeasible. In this regard, the existence or the coming into existence of such powers in a trust means that the trust can never be a fixed trust in the absence of the exercise of the Commissioner’s discretion in the trust’s favour. That the law can be so uncertain on its terms in this instance speaks volumes about the inappropriateness of the existing test.

The purpose of the Commissioner's discretion, as pointed out in the Discussion Paper, is to assist in cases where the likelihood of the beneficiary's vested interest in fact being defeated is low and it would not be unreasonable in the context of the statutory scheme to treat a beneficiary's interest as being "fixed" even though technically the trust does not meet the definition of being a "fixed trust". In practice, however, there is an over-reliance on the exercise of the Commissioner's discretion to determine whether a trust is fixed or not and in all likelihood, the discretion has been relied on more than ever was intended. It is clearly not having the "narrow, targeted function" referred to in the Discussion Paper that it was intended to have which supports the fact that the definition of "fixed trust" does need to change to ensure that there is limited need to rely on the discretion. This evokes the question what role the Commissioner's discretion should have in determining whether a trust is fixed or not.

In our view, depending on how the term "fixed trust" is finally defined, limited dependence should be placed on the Commissioner's discretion consistent with the original intention. There will always be trusts which fall short of the definition of a "fixed trust" simply on the basis that there are powers in the instrument or statute that will cause it to fail to meet the definition. However, if the likelihood of a vested interest being defeated is low and it would not be unreasonable to treat a beneficiary's interest as "fixed" in spite of the existence of powers, the exercise of which might defeat the interest, there is a place for the exercise of the Commissioner's discretion to continue to remedy these situations and consequently a need for such a discretion to exist.

Based on the comments noted above, it is appropriate to provide that an entitlement is not to be regarded as defeasible simply because of the existence of certain powers. However, it is neither appropriate nor possible to comprehensively specify the existence of which particular powers either contained in a trust instrument or statute should not result in an entitlement being regarded as defeasible. This is because it is not realistically possible to identify all powers that may be capable of defeating an interest. Further, whether certain powers may or may not be seen to be offensive in the sense of being capable of defeating an interest may often depend on the context in which a particular power is being used.

Question 4

Is the definition of 'indefeasible' as set out in *Colonial* too restrictive in the context of provisions that use the term directly or indirectly (other than in relation to 'fixed trusts')?

The definition of "indefeasible" is so broad that it is difficult to utilise the concept for the purpose of defining another concept (such as "fixed entitlement") on which other concepts (such as "fixed trust") are ultimately dependent. The breadth and consequent instability of the concept of "indefeasible" cascades through to the concepts which are dependent on it making each and every other concept in turn unreliable. This creates unnecessary uncertainty in an already complex and uncertain area of law.

Question 5

Could a 'clearly defined rights test' be used to determine whether a trust is a fixed trust? If so, should additional safeguards be introduced, particularly in relation to trusts that are not publicly listed or widely held, and what should they be?

In our view, the reform option of using a "clearly defined rights" test, which appears to require a prospective examination to determine whether a trust is fixed or not, does not appear to be materially different to the current test, which also provides a prospective examination to determine whether a trust is fixed or not. This proposed test is as inexact as the current "fixed trust" test and will add no certainty whatsoever to the current position at law. Inclusion of the "clearly defined rights" test would basically represent substituting one unclear test for another.

Also, it is likely to only effectively operate when applied to a trust that has a written instrument, creating uncertainty about how to determine if a trust that does not have a written instrument could be determined to be "fixed" (however, please note our comments in response to Question 2).

Question 6

Which powers, if any, is it appropriate to prescribe as constituting or not constituting material discretionary elements for the purposes of determining whether a trust is fixed? Should a different approach be applied for different purposes and how might the different approach(es) apply?

If discretion is availed upon the Commissioner and a "clearly defined rights" test is to be adopted, it is anticipated that there would be an element of materiality adopted by the Commissioner in exercising the discretion. In the absence of a materiality element being included in the discretion, it could be useful to include a material discretionary element for the purpose of determining whether a trust is fixed or not in this context.

However, it is not appropriate to prescribe which powers constitute or do not constitute a "material discretionary element" for the purpose of determining whether a trust is fixed or not as this will always depend on the context. What is used as a power for a proper and straightforward, commercial purpose in one context may be subject to some form of perceived "abuse" or wholly inappropriate in another context. For example, the application of overhead expenses to one class of beneficiaries and not another could constitute a "material discretionary element" and may be regarded as either appropriate or inappropriate depending on the context in which the power is exercised.

Attempting to define which powers should or should not be prescribed will be incredibly difficult to undertake and there is unlikely to be any majority agreement about the relevant powers to be prescribed among the profession and is therefore an exercise The Tax Institute recommends not be undertaken.

Question 7

Is it appropriate to allow fixed trust treatment where rights are vested but are not indefeasible? If so, in which cases is it inappropriate?

A second reform option, as noted in the Discussion Paper, is to require an interest to be “vested and not defeated”, being a more certain threshold than the current test which requires an interest to be vested and indefeasible. Making a “vested and not defeated” determination would require a retrospective examination to see whether an interest has in fact been defeated (by the exercise of a power by the trustee). We have termed this test the “wait and see” test and it is the preferred reform option of The Tax Institute.

Under this test, an interest would still be required to be “vested”, which is an element in our view that should be retained. However, the interest could be defeasible (in the sense the courts have recently interpreted that concept) in which case the question would become whether the interest has, in fact, been defeated (by an exercise of a trustee power or by some other means). The test would require a person to “wait and see” whether a power has been exercised that has in fact defeated an interest. Importantly, this test is fact-based and does not effectively require some prediction as to possible, even if remote, possibilities.

An element of the test could involve examination of the administration of the trust over the relevant period to see if it has been administered as a “fixed trust” even though it does not strictly meet the definition of being a fixed trust. This would usually require waiting until the end of an income year before making this determination.

This kind of test would give practitioners/taxpayers some certainty in being able to determine whether a trust is fixed or not and would allow taxpayers to be much less reliant on the exercise of the Commissioner’s discretion. An increased level of certainty in the test to determine whether a trust is fixed or not would give the use of the Commissioner’s discretion the narrow, targeted application it was originally intended to have (noting that this would not, and should not, eliminate the need for the Commissioner to have discretion altogether).

In this regard, it is wholly appropriate to allow fixed trust treatment where rights are vested but are not indefeasible. However, it is not appropriate to specify the cases in which it is appropriate as it will depend on the particular facts and circumstances surrounding the trust under examination (but which will be known when the time arrives to apply the test).

Question 8

If a ‘vested but not defeated’ test is adopted, what rules might be adopted to identify whether the rights have effectively been defeated?

It is difficult to specify what rules could be adopted to identify whether the rights have effectively been defeated. Rather, it would be more appropriate to devise an objective test as to whether rights have effectively been defeated. This will ultimately depend on the facts and circumstances of the particular trust, such as whether the trustee has acted reasonably and equitably in exercising their powers as among the beneficiaries of the trust. This would require exploration of whether a power has been exercised to defeat an interest and how a trustee has exercised the powers afforded to them under the trust.

Question 9

For provisions that do not seek to determine continuity of ownership, is it sufficient that the rights have not been defeated at the time the test is applied? If not, what minimum period might be appropriate? Is there a more appropriate way of removing the 'fixed trust' concept from tests that are used for identifying continuity of ownership?

The relevant approach to take is to determine what the object is of the test in question. In this case, the object of the test is to find the economic "owners" at particular points in time and therefore to trace through the entities to those economic owners. In our view, the second reform option of using a "vested and not defeated" test best allows this tracing to occur.

Question 10

For provisions that use the fixed trust concept to determine concentration of ownership and control, is it appropriate to include a de facto control test based on the test in section 727-360 of the ITAA 1997? Is there a more appropriate way of removing the 'fixed trust' concept from tests that are used for tracing ownership and control?

Whether or not a de facto control test should be added to a fixed trust test depends on the policy objective sought to be achieved. While a de facto control test on top of a fixed trust test may be appropriate to deliver the legislative safeguards required in the context of value shifting, it may be entirely inappropriate in the context of closely held trusts. This is another example of the need to understand the precise policy objectives which are sought to be achieved before one form of test is introduced rather than another.

In regard to the second part of the question, we do not regard the introduction of a de facto control test in substitution for a fixed trust test as desirable. It should be an integrity measure used in the last resort.

Question 11

Which provisions lend themselves to removing the distinction between fixed trusts and non-fixed trusts? What safeguards would be required?

To determine whether certain provisions lend themselves to removing the distinction between fixed and non-fixed trusts depends on the policy intent behind each of these provisions in which the distinction has been made. If the distinction is critical to the provision properly evoking the policy intent, some form of distinction may remain appropriate; if the distinction is not critical, it should be removed. Therefore, an examination of the policy intent behind each of the provisions which contains the distinction is required.

We note that this distinction has already been removed from some of the existing provisions, such as in the tax consolidation sections referred to in the Attachment.

Question 12

Should 'closely held trust' be defined for the purposes of the ITAA 1997 and should other provisions rely on that definition rather than replicating it? In particular, how can the differences in the provisions dealing with the concentration of ownership and control be reconciled?

The "closely held trust" provisions contained in Division 6D of the ITAA 1936 seem to serve a completely different purpose to the fixed trust rules. We are not certain that this set of rules needs to be considered during a review of the concept of "fixed trust".

Question 13

Is it appropriate to bring the definition of connected entity into line with the other provisions by referring to the 'capital of the trust' instead of the 'corpus of the trust'?

Reference is made to section 170-265(1)(a)(i) ITAA 1997. We are uncertain as to the distinction that is being drawn between the "corpus" of the trust and the "capital" of the trust as the terms "capital" and "corpus" of a trust are commonly used interchangeably. Of course, it is always possible that a deed may draw a distinction between the two.

If you would like to discuss any of the above, please contact either me or Tax Counsel, Stephanie Caredes, on 02 8223 0011.

Yours sincerely

A handwritten signature in cursive script, reading "Ken Schurgott". The signature is written in dark ink and is positioned above the printed name and title.

Ken Schurgott
President