CLAYTON UTZ

ENTITY TAXATION

Exposure Draft: New Business Tax System (Entity Taxation) Bill 2000

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Failure to Meet Basic Standards of Simplicity and Certainty

1. In adopting Div 272 of Schedule 2F of the 1936 Act as the means of identifying "non-fixed trusts", the Exposure Draft:

    - casts an intolerable compliance burden on taxpayers (a failure to meet the simplicity criterion);

    - opens vast areas of uncertainty of interpretation (a failure to meet the criteria of certainty of liability and incidence);

    - effectively passes broad areas of operation over to an uncertain discretion vested in the Commissioner of Taxation (an impermissible abdication of law-making authority).

2. The definitions of "fixed" and "non-fixed trusts", drafted to serve anti-avoidance purposes in Sch 2F, are completely inappropriate as definitions for general commercial purposes, where they must deal with a much wider range of factual circumstances in relation to all forms of trading and investment activities (not just tax losses), and without the related rules in Sch 2F regarding family trusts, unlisted widely held trusts, listed widely held trusts, unlisted very widely held trusts/ wholesale widely held trusts.

3. According to the Explanatory Memorandum (para 3.4), the concept of "net income" is no longer relevant under the new regime. Why then is the definition of a "non-fixed trust" drawn from provisions (Sch 2F) that were drafted in connection with a regime that is based on trusts taxed under the Div 6 net income regime? Why is there a reluctance to simply define a "discretionary trust"? The NSW *Duties Act* 1997 contains a definition of "discretionary trust" in the Dictionary. Some of the constituent concepts are used in section 960-120 regarding the scope of "membership interests". There seems to be no reason why the legislation should not use terms that match common commercial practice. The approach adopted simply creates a great deal of confusion regarding unit trusts where there may be a degree of contingency associated with the interest conferred by a unit.

4. The provisions require a fixed vested and indefeasible interest in income and capital at all times during a year of income. This is quite inconsistent with the nature of the interest held by most unit holders, including unit trusts where the fractional interests in potential distributions are equal and proportional. How can there ever be a vested and indefeasible interest on a daily basis?

5. Why does the drafting focus on the minority (provisions designed to combat artificial avoidance) rather than on the vast majority of conventional private and public unit trusts that are established with unit interests that are fundamentally equal and proportional, but with a conventional power of amendment?

6. Why do the provisions not distinguish between public and private fixed trusts? The situations are vastly different and it greatly increases compliance costs when a single brief set of rules is applied to very different commercial circumstances.

7. Is an interest "defeasible" only when it is "vested", or is it possible to have an interest that has

not yet "vested" that is also "defeasible"?

8. The following examples illustrate the practical compliance difficulties and uncertainties posed by the drafting adopted:

(a) ***when does an entity have a fixed entitlement to a share of "income" of a trust?***

"Income" is the most notoriously uncertain word in the Act. It does not mean "assessable income", nor "net income" within Div 6 of the 1936 Act, nor "accounting income". It means "income according to ordinary concepts".

No unit holder or beneficiary ever, "under a trust instrument" has a "vested and indefeasible interest in a share of income that the trust derives from time to time", as stated in section 272-5(1), and certainly not on a daily basis. Unit holders/beneficiaries only acquire interests in a share of either the tax net income (section 95) or trust net income, as determined at year end.

(b) ***what is meant by "fixed entitlement"?***

It is clear that "entitlement" has no meaning other than "vested and indefeasible interest", within section 272-5(1). For example, it does not mean "present entitlement". But these are highly technical terms that have no clear meaning to ordinary taxpayers or to a large proportion of tax practitioners.

The only guidance provided is the negative rule in section 272-5(2). For all other situations, across the entire range of public and private trusts, we are left with the discretion given to the Commissioner by section 272-5(3). This is an entirely unacceptable delegation of the Parliament's responsibility to legislate.

(c) ***do the following preclude a "fixed entitlement" from arising:***

(i) a definition in a trust deed of "distributable income" that is limited to section 95 tax net income, which might be lower than the "income" of the trust?

(ii) the existence of a discretion in a trust deed vested in the trustee to decide that an assessable capital gain should be treated, for trust purposes, as capital (or income) ?

(iii) a power in the trustee to issue more units in a unit trust, whether at a discount/premium or otherwise, and with or without the consent of existing unit holders?

(iv) the mere existence of a power to redeem units on terms outside section 272-5(2), for example, not solely for a redemption price on the basis of net asset value according to "Australian accounting principles"?

(v) the mere existence of a power to amend the trust deed in a way the might alter the membership of the class of unit holders, or the identity of unit holders, or their interests, with or without their consent?

In short, is "indefeasible" meant to be taken literally, so that the slightest element of contingency is enough to make the interest "defeasible", or is it subject to some "rule of reason" - other than the discretion given to the Commissioner? If an entitlement is defeasible but only with the consent of the holder, is that still "indefeasible"?

9. The discretion given to the Commissioner in section 272-5(3) is an entirely impractical method of dealing with uncertain cases. Although it may have been appropriate in the anti-avoidance context of Schedule 2F, in the very different context of general commercial operations it is simply an unwarranted burden on taxpayers that an application must be made to the Commissioner for the exercise of his discretion. In addition, the factors to which regard must be given in the exercise of the discretion are far too narrowly drawn.

10. No doubt the Revenue Authority is concerned to achieve measures that protect the revenue. But it is submitted that the tax laws must also serve the needs of the vast bulk of the taxpayers who genuinely seek to meet their obligations. If they are faced with complexity and uncertainty that escalate the costs of compliance, the tax laws fall into disrepute. Why should the views of a trust lawyer, and a detailed written submission to the Commissioner, be necessary to resolve the huge number of ordinary questions of interpretation that the deficient drafting will throw up?

Irrevocable Status of Non-Fixed Trust Rules

11. The justification given for the rule in section 153-25(2), to the effect that the non-fixed trust rules apply irrevocably, is entirely unsatisfactory. No justification is given that is remotely convincing for the perceived risk that trusts may "swap between treatment under the non-fixed trust regime and treatment under Division 6 … whenever it is advantageous to do so". (para 2.9 of the Explanatory Memorandum). This comment completely ignores the commercial significance of alterations of that kind, as well as the many practical restrictions that apply, in terms of stamp duty and capital gains tax implications. The enormous concerns generated merely by the changes needed to comply with Corporations Law Managed Investment Scheme changes clearly indicates that concerns that arise if changes are made to trust deeds. Taxpayers must also have regard to the Commissioner's guidelines on trust resettlements. It is simply not good enough for glib statements of that kind to be made in publications issued under the authority of the Treasury.

The vast bulk of taxpayers who seek to fully comply with their taxation obligations deserve a more serious attempt to devise a rule that applies the provisions in a fair and reasonable manner, with allowance for exceptions where appropriate. Surely this would be a case where a discretion of the kind in section 272-5(3) would be appropriate? Indeed, as argued above, it is appropriate in this situation but is not appropriate for the purpose it is actually used.

"Available Profits"

12. The definition in section 157-85(1) of "net market value of assets" conspicuously fails to mention anticipated tax liabilities (which though quantifiable would not be present "legal obligations" to use the term in para 4.11 of the Explanatory Memorandum). In addition, the definition of "accounting provisions" fails to mention tax effect accounting. Although this may be contemplated as something to be covered in the regulations, the failure to acknowledge such an obvious limitation on profits as tax liabilities is a source of concern.

Restructuring

13. The introduction of these measures, although foreshadowed, represents a radical change to the fundamental nature of vast numbers of public and private trusts. Due to the delayed issue of the legislation as actually proposed (more of which is still anticipated), the time available to examine trust deeds and make judgments about future arrangements is very limited.

In this limited time an enormous number of public and private trust deeds will have to be reviewed and decisions made about the commercial operations that will commence on 1 July 2001. The new regime is radically different from that which has become accepted in the community. It is clear that many changes will need to be made to accommodate the new system. Unless some degree of capital gains tax roll-over relief, and State/Territory stamp duty relief is provided, taxpayers will face a large additional expense, quite apart from the additional compliance cost of gaining an understanding of the new rules. This additional cost will arise purely as a by-product of the reforms and not through any actions by taxpayers designed to avoid their taxation obligations. The introduction of the proposed regime without these matters being given equal attention represents an unconscionable disregard of the willingness of the vast bulk of taxpayers to faithfully discharge their taxation obligations.

Regrettably, time has not permitted a more detailed analysis of the Exposure Draft and therefore a more detailed response, not that any of these submissions will make the slightest difference.

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