6 November 2000

Ms Christine Archer
Manager
International and Entities Tax Units
The Treasury
Parkes Place
CANBERRA ACT 2600

Dear Christine

NEW BUSINESS TAX SYSTEM (ENTITY TAXATION) BILL 2000

We appreciate the opportunity to provide comments on the above Bill.

The Investment and Financial Services Association represents the funds management industry in Australia, with a combined $550 billion of assets under management, comprising the investments of over 9 million Australians.

This submission is endorsed as a joint submission representing the views of the Australian Venture Capital Association Limited, the Property Council of Australia and the Tourism Council of Australia.

The matter of fundamental concern to our industries is the definition of "fixed trust". It is essential that this definition is simple and certain.

In our industries, unit trusts are the means of collective investment. The concept of "vested and indefeasible" is often uncertain and complex and there is an opportunity to clarify this and other trust law concepts.

We set out below our views on the matter and a suggestion for improving the definition.

(1) Fixed Entitlements Throughout Income Year

The Bill contains a definition of fixed trust expressed in terms that entities must have fixed entitlements to all the income and capital of the trust; s995-1(1). This requirement must be met at each point of time during the income year; s153-25.

This is significantly different from the concept of "present entitlement" contained in Division 6 of ITAA 1936. There it is only necessary to determine whether at a point in time in an income year a beneficiary has the present entitlement to a share of trust income in respect of that year.

(2) Schedule 2F

The Bill defines fixed entitlement by reference to Division 272 in Schedule 2F of ITAA 1936.

In our view it is relevant that the definition of fixed trust for the purposes of the Bill serves a different purpose to that for Division 272, which is concerned with the carrying forward of trust losses.

The Bill's definition is the critical gateway to treatment of a trust as either a taxed entity or pass through vehicle. It is the building block to the new system. Investors need to know in advance what type of vehicle they are investing in. Similarly our industry has to be in the position of knowing with certainty and in advance that each particular investment unit trust passes the fixed trust test on each day of each year of income. The consequences of failing the test would have a severe impact on investors, and the industry.

The purpose of Schedule 2F is expressed in the Explanatory Memorandum to the legislation, which introduced Schedule 1 which contained Schedule 2F:

> "Schedule 1 of the Bill will insert rules into the ITAA 1936 to restrict the recoupment of prior year and current year losses and debt deductions of trusts in order to prevent the transfer of the tax benefit of those losses or deductions. The tax benefit of a loss is transferred when a person who did not bear the economic loss at the time it was incurred by the trust obtains a benefit from the trust being able to deduct the loss."

It is clear that the thrust of the trust loss measures is to ensure that persons who did not bear the economic loss in the trust at the time it was incurred do not obtain a benefit from the trust being able to deduct the loss.

Where a trust is not classified as a fixed trust for the purposes of Schedule 2F it is not thereby denied the ability to carry forward trust losses. This is unlike the test of fixed trust in the Bill where failure to meet the test results in the trust being taxed quite differently as a non-fixed trust. Where a trust fails to meet the requirements of the Schedule 2F test for a fixed trust different tests exist for determining whether losses can be carried forward. The matter is stated in the following terms in the Explanatory Memorandum to the Schedule 2F legislation:

> "Since non-fixed trusts are different in nature to fixed trusts, different rules apply to determine whether a non-fixed trust can deduct a prior year or current year loss or debt deduction. Non-fixed trusts are different to fixed trusts because it is not possible to determine who has a vested and indefeasible interest in all the income and capital of the trust. This is because the trustee or some other person will generally have a discretion as to who will benefit under the trust and/or what the amount of the benefit will be. Alternatively, the interests of persons in the trust may change because vested interests may be defeated or the vesting of the interests is conditional. It is not, therefore, possible to apply the same continuity of ownership test that applies to fixed trusts. Instead, the pattern of distributions or control of the trust are tested to give a picture of the individuals who benefit from the trust."

In other words the definition of fixed trust for the purposes of Schedule 2F is not a test for denial of carry forward of trust losses. Rather it is one of a series of classified descriptions in order to apply the appropriate trust loss rules.

(3) Vested and Indefeasible

The words used in Schedule 2F to describe a fixed trust are that of vested and indefeasible interest of a beneficiary in a share of income or capital of a trust; s272-5(1).

The words "vested and indefeasible" are technical trust law words described by Hill J as:

> "The words "vested" and "indefeasible" in the context of trust law are technical legal words of limitation." Dwight v FCT (1992) 23 ATR 236, at 248."

In Walsh Bay Developments v FCT (1995) 31 ATR 16 at 27 Beaumont and Sackvill JJ had this to say on the subject:

> "A vested interest is one where the holder has an "immediate fixed right of present or future enjoyment": Glenn v Federal Commissioner of Land Tax (1915) 20 CLR 490, at 496, per Griffith CJ. In relation to land, an estate is vested in possession where there is a right of present enjoyment, as where A has a life estate or fee simple estate in the land. An estate is vested in interest where there is a present right of future enjoyment. Thus where T holds in trust for A for life and then in trust for B in fee simple, B's equitable fee simple estate is vested in interest during A's lifetime. The estate will vest in possession on A's death: Glenn v Comr, at 496, Dwight v FCT, at FCR 192.
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> All estate is contingent if the title of the holder depends upon the occurrence of an event which may or may not take place: E H Barr, Cheshire's Modern Law of Real Property (11th ed 1972), 241. However, the mere fact that an estate will not fall into possession until the regular determination of a prior estate does not make the first estate contingent. As stated in C Fearne, Contingent Remainders and Executory Devises (10th ed, 1844), vol 1, 216:
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>> "It is not the uncertainty of ever taking effect in possession that makes a remainder contingent, for to that, every remainder for life…is and must be liable, as the remainder-man may die…before the death of the tenant for life. The present capacity of taking effect in possession, if the possession were to become vacant, and not the certainty that the possession will become vacant before the estate limited in remainder determines, universally distinguishes a vested remainder from one that is contingent."
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> For these reasons it is said that before a beneficiary is entitled to a vested interest two things must occur:
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> (a) his identity must be established;
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> (b) his right to the interest (as distinguished from his right to possession) must not depend upon the occurrence of some event. (See Cheshire's Modern Law of Real Property, 242).
>
> The distinction between a vested but defeasible interest and an indefeasible interest is stated by Fearne (vol 2, 30) as follows:

> "A defeasible interest is an interest that is to be defeated by the operation of a subsequent or mixed condition.
>
> An indefeasible interest, or an absolute interest as opposed to a defeasible interest, is one that is not subject to any condition."

There is also a distinction between a contingent interest and a defeasible interest. The latter is a vested interest, which is liable to be divested by a supervening event. This distinction is not always easy to apply."

In Jacobs' Law of Trust, 6th Ed at 940 the following discussion takes place on the nature of vested interests:

"The meaning of 'vested' in connection with the rule is 'vested in interest' as distinct from 'vested in possession'. Before an estate or interest is or may become vested in this sense, three essentials must be fulfilled:

(1) The person or persons, corporation or body to whom to which it is given is or are ascertained and in existence and capable of being an alienee;

(2) The *quantum* of estate or interest is definitely fixed; and

(3) All other events have happened to enable the estate or interest to come into possession at once, subject to the determination at any time of the prior estates or interests.

Thus, if there is a grant to A for life remainder to B in fee simple, A acquires a vested life estate in possession and B a vested estate in remainder at the date of the grant. As B is an ascertained person, the quantum of his estate is fixed, and as there are no uncertain events which must happen before B is entitled to possession on the death of A, B has a certain, a valuable, and a legally protected interest which he may freely dispose of at any time. The rule against perpetuities is not concerned with such interests. But if there is a grant 'to A for life remainder to B if he attains the age of 21 years' an event must happen, the attaining of 21 years, before B's interest will be ready to come into possession at once on the determination of the prior estate."

Hill J considered the term "vested and indefeasible interest" as contained in s 95A(2) more recently in Trustees of the Estate Mortgage Fighting Fund Trust v Commissioner of Taxation [2000] FCA 981(31 July 2000) and stated at para 55:

"The subsection has been considered by a Full Court of this Court in Commissioner of Taxation v Harmer (1990) 24 FCR 237, by myself in Dwight v Commissioner of Taxation (1992) 37 FCR 178 and by another full court in Walsh Bay [(1995) 31 ATR 15]. In summary these cases make clear that an interest in income will be vested where the holder has an immediate fixed right of present or future enjoyment. A contingent interest would not suffice. An interest will be indefeasible where it is not subject to any condition."

The above illustrates that the words “vested and indefeasible” relate historically to English land interests of life estates and the like, rather than modern unit trusts.

(4) Examples of the Uncertainty for Unit Trusts

In our industry unit trusts are the means of collective investment. Any attempt to apply the concept of “vested and indefeasible” to them will create uncertainty and complexity.

We detail below some examples:

(a) Determining Distributable Income

We enclose clauses which appear in unit trust instruments concerning the right of unitholders to share in distributable income and for the responsible entity to determine distributable income.

There are historical and current reasons why unit trust instruments confer on the responsible entity a discretion in determining distributable income. Distributable income will often exceed taxable income or trust law income, this being the measure of performance for managed trusts. The discretion also allow the distribution to be rounded up or down. The discretion is also necessary in many circumstances to ensure double tax agreements operate correctly.

Where such a provision exists we would wish to avoid any conclusion that a unitholder does not have a right to a share of trust law income.

(b) Share of Income

We enclose clauses which appear in some unit trust instruments concerning a unitholder’s share of income. Again there are numerous variations.

The technical issue is whether it can be said that throughout the year of income a unitholder has a fixed right to a share of income when that share is not ascertainable until year end and that share is within the power of the trustee (and on some occasions the unitholders) to determine by issuing more units or redeeming units during the year.

(c) Amendment of Trust Deed

We enclose clauses which appear in unit trust instruments concerning amendment of the instrument. Again there are many variations.

Here the technical issue is whether the interest of a unitholder is defeasible when other unitholders may vary the trust deed so as to adversely affect the unitholder’s rights to income or capital. In this respect s960-110 of the draft CIV legislation reflected a view that such power is relevant in determining whether the entity was widely held.

(d) Redemption of Units

We enclose clauses which appear in unit trust instruments concerning the redemption of units. There are of course many variations.

The technical issue is whether a unit is a defeasible interest if there is power in the trustee to redeem the unit - and whether it makes any difference that the redemption price may not equal the offer sale price or asset backing; s272-5(2).

The High Court recently grappled with redemption of units in MSP Nominees v Commissioner of Stamps (SA) (1999) 42 ATR 833 and for the purposes of the unit trust instrument there under consideration held that the redemption of the units was an exercise of the rights of the unitholders not a surrender or renunciation (the Full Court of the Supreme Court of South Australia had reached the appropriate conclusion). But does it follow that a unitholder's interest is defeasible if it may be taken away.

(e) Issuing New Units

We enclose clauses which appear in unit trust instruments concerning the issue of new units. Again there are numerous variations.

The technical issue is whether the power to issue new units at less than the offer sale price (listed units) or asset backing (unlisted units) affects whether a unitholder has a vested and indefeasible interest in income and capital.

It is common practice in our industry for trusts to issue units at less than the prices referred to in s272-5(2) eg unit reinvestment plans, series of fund raisings, variable entry fees (because there is no advisor or the advisor has "rebated" commissions) etc.

This raises concern whether the existence of the power to issue new units results in the trust not being a fixed trust.

(f) Share of Capital

We enclose clauses which appear in unit trust instruments concerning a unitholders interest in the capital of the trust. Again there are numerous variations.

In the MSP Nominees case referred to earlier the High Court had this to say on the subject (at 841):

> "As effected by cl 4 of the Trust Deed, the Unit Holders were denied any specific interest in any item of property held in the Trust Fund. Rather, the rights enjoyed by Budget and Galaxy as Unit Holders were, upon favourable exercise by the Trustee of its discretion conferred by cl 34, transmuted by the redemption process into the entitlement to the price arrived at by the valuation for which cl 36 provided. This, as indicated

> earlier in these reasons, was in fulfilment of the rights of Budget and Galaxy, not the 'surrender', in the sense of that term in the definition of 'transfer' in s 71(15) of the Act, of a beneficial interest or potential beneficial interest in or in relation to the assets represented by the Trust Fund."

Again this creates unnecessary uncertainty as to whether a unitholder has a vested and indefeasible in the capital of the trust.

(g) Accumulated Income

We enclose clauses which appear in some unit trust instruments concerning the power to accumulate income. Again there are numerous variations.

The technical issue is whether the accumulated income must be held for the benefit of the unitholders who were unitholders in the year the income was derived or whether it matters that the accumulated income is available to the unitholders at the time the accumulated income may be distributed to future unitholders.

(h) Performance Units

We enclose clauses which appear in some unit trust deeds concerning performance units. Again there are numerous variations.

The technical issue is whether the existence of such units where the income attributable to them is based on performance by a particular unitholder or its associates and where other units share of income may be affected causes the trust not to be a fixed trust under the current definition.

(i) Discretion to Distribute Income or Capital on Redemption

We enclose clauses which appear in some unit trust instruments that provide that on redemption a unitholder is not entitled to income or capital gains dividend since the last balance date unless the trustee exercises its discretion.

Such a power may result in the trust not being a fixed trust.

(5) One Strike Rule

The concern with a trust unwittingly not being a fixed trust will be greatly reduced if there is a simple and certain definition of fixed trust. Additionally, there should be a Commissioner's discretion.

(6) Stamp Duty Relief

Again the necessity for stamp duty relief may be overcome if there is a simple and certain definition of fixed trust which can be met by existing trusts without amending the trust instrument.

(7) Recommended Change

We consider that simplicity and certainty can be achieved if the definition of fixed trust in s995-1(1) read as follows:

"**Fixed Trust:** a trust is a fixed trust if:

(a) entities have fixed entitlements to all of the income and capital of the trust, or

(b) it is a registered managed investment scheme or an investor directed portfolio service – like product in accordance with ASIC Policy Statement 148 as amended, or

(c) it is a unit trust and at least 25% of the units in the trust are held by one or more trusts that are a registered managed investment scheme or investor directed portfolio service like product in accordance with ASIC Policy Statement 148 as amended; or

(d) it is a unit trust and at least 75% of the units in the trust are held by two or more non-associated unitholders; or

(e) the trustee has no discretion to distribute income or capital to one unitholder to the exclusion of any other unitholder, except in calculating the amount payable on redemption of a beneficiary's interest where that amount is calculated as an *arms length price, and the issue or redemption of beneficiary's interests in the trust is at an *arms length price, or

(f) The Commissioner prescribes within the Income Tax regulations that the trust is a fixed trust.

Arms Length Price: an amount is an arms length price if it is a price that would be calculated between parties who were dealing at arms length."

By adopting an "arms length price" rule for distributions on redemption, and the issue and redemption of units, existing commercial practices that do not derogate from the policy of fixed trusts, can continue to operate. The requirement of offer price for listed trusts or net asset value for unlisted trusts is then not necessary. This addresses the concerns for distribution reinvestment plans and the like which offer new units at a discount. It also addresses the distribution to a redeeming unitholder, where the trustee is afforded the discretion to distribute the outgoing member's share of income or capital to maintain investor equity.

(8) Additional Issues

There are a number of additional issues related to the Bill on which we wish to provide our comment:

PAYG

The PAYG rules contained in Taxation Laws Amendment Bill No. 7 should be amended to be integrated into the fixed trust regime. That is, that beneficiaries of fixed trusts should only be required to bring to account income accruing within a trust, for PAYG purposes, if the income was distributed to them during the quarter.

Where possible industry should be required to apply only one set of rules to its different compliance obligations.

International - Investments

We require some clarity on the status of foreign trusts in which Australian investment trusts may invest. For example, a fund manager may offer to Australian investors a strategy to invest in international property securities by investing in US REITS and trusts in other common law jurisdictions that invest in property in their country. What is the status of the foreign trusts and the returns from those trusts? Will they be treated as deemed companies and will this depend on the existence or absence of a DTA?

Foreign Investors

A long standing concern of the industry in attracting overseas investment (or "exporting" our managed funds expertise) has been the lack of equivalence for foreign investors between investing directly in Australian assets and indirectly via a managed fund vehicle (trust). If a foreign investor holds shares directly in a listed Australian company of less than 10% no CGT would be suffered by that investor on selling that investment. However, if the same investor was to invest in an Australian publicly offered unit trust, which in turn had a holding of shares directly in a listed Australian company of less than 10%, the trust would need to include any gain on the sale of those shares in the calculation of net income of the trust and withhold tax on the distribution to the foreign investor of that gain. Thus, CGT would be suffered by that investor on the trust selling the same investment that wouldn't have attracted Australian tax had it been held directly. We believe this should not be the case. We request that this anomaly be amended to ensure consistency of approach between investors.

Franking

We welcome the amendments proposed that seek to give Australian companies credit for foreign withholding tax paid on overseas dividends. Whilst these provisions go some way towards eliminating the additional Australian tax currently paid by shareholders on foreign earnings of Australian companies, there are still some substantial inequities within the system.

For example:-

Firstly, there is no reason why there should be a 15% cap or limit on the amount of imputation credits available to be credited - if withholding tax is paid at a higher rate (ie, due to the absence of an International Tax Treaty) taxpayers should not be disadvantaged.

Secondly, as currently drafted, a credit is only given for the payment of foreign withholding tax. We believe these provisions should be extended to provide a credit for corporate tax paid within the overseas jurisdiction, by a foreign subsidiary of an Australian company. Such a proposal would ensure tax on foreign earnings of an Australian company is limited to, at most, the tax paid in the foreign jurisdiction in cases where the tax rate payable overseas is greater than that payable in Australia.

Finally, the rules by which a corporate shareholder is treated in the same way as an individual are unclear as to the receipt of unfranked dividends. The draft Explanatory Memorandum suggests that the current section 46 rebate is to be abandoned. This would have a significant impact on reported profits for publicly listed companies in which our members invest. This approach is similar in nature to that proposed in the Deferred Companies Tax regime, which was rejected by the Ralph Committee. Please confirm that section 46 will be retained.

If there are any matters which further discussion would clarify and advance we would be prepared to meet with you in coming days. You could contact me on 02 9299 3022. Thank you for the opportunity to make a submission on this matter.

Yours faithfully

Richard Gilbert
Deputy Chief Executive Officer