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Submission on Non-fixed Trusts

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

KPMG Tax

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1 Introduction

The following submission assumes that the Non-fixed Trust ('NFT') regime will be ultimately legislated. Accordingly, the issues raised and the suggestions made should be read in that context.

There are a number of identified practical issues that have not been included in this submission as this submission is limited to issues considered to be of a higher priority.

We would appreciate the opportunity to discuss with representatives of your Office both the issues canvassed in this submission, and, the additional practical issues not so canvassed.

2 Fixed trust : non-fixed trust distinction

Clearly critical is the definition of "fixed trust" contained in section 995-1(1) of the Exposure Draft legislation which determines the taxation treatment to be applied to a trust. It is essential that this definition be clear and precise in the legislation itself.

The most appropriate recommendation would have been for KPMG to draft a suggested alternative definition of 'fixed trust'. However, KPMG understands that other groups such as the Property Council of Australia, Tourism Council of Australia and possibly IFSA are making a submission on a potential alternative definition. Accordingly, the most sensible practical recommendation is for a small working group comprising representatives from the ATO, Treasury, the above-mentioned lobby groups, KPMG and any other relevant interested party be formed. Such group would then work together to develop a more acceptable definition.

What follows is a discussion of some of the specific concerns arising from the proposed definition of 'fixed trust'.

2.1 Fixed Trust definition

Issue:

The definition of "fixed trust" refers to a "fixed entitlement" which, in turn, is defined in section 995-1(1) of the Exposure Draft by reference to Division 272, Schedule F of the 1936 Act. Applying section 272-5(1) of the 1936 Act, a member will have a "fixed entitlement" if he or she has a "vested and indefeasible interest" in a share of the trust income or capital. This legal concept of "vested and indefeasible interest" is highly technical, unclear and uncertain.

Currently, Division 6 of Part III of the 1936 Act requires a determination at year end as to whether or not there is a present entitlement to all of the income of the trust estate for that year of income. In other words, it is a 'once in a year' test. By contrast, under Division 272, whether an entitlement is a "fixed entitlement" is determined on a continual basis throughout the whole of the income year. Moreover, a "fixed entitlement" to all income at any point in time means that one would accrue entitlement to that income on a minute by minute basis, instead of it being more properly linked to an income distribution to be made at any particular time.

Applying a strict interpretation of the existing definition under Division 272, if a unit holder was to sell units in a unit trust before an income distribution, it is arguable that the "fixed trust" requirement is not satisfied. This is because the income of the trust that accrued whilst that person was a unit holder will be distributed to the successor unit holder. In other words, the unit holder did not have a truly vested and indefeasible right to all income of that trust whilst he was a unit holder. Accordingly, the unit trust is not a "fixed trust" for tax purposes.

Further it is not clear what level of ownership is examined to determine whether a trust is a 'fixed trust'. For example, where a trust holds an interest in a trust, is there a tracing of interests.

The fact that potential alternative interpretations of such a critical definition exist is unsatisfactory and should not be remedied by practical administrative practice of the ATO, as has occurred in prior tax audits.

This issue can be further highlighted by a brief consideration of the substantial debate that occurred regarding the legal accuracy of many of the statements in the Explanatory Memorandum for the trust loss provisions when those provisions were introduced. It is important to note that, this time around, the impact of the proposed NFT provisions is significantly greater than the impact of the trust loss provisions.

One of the critical concerns is that many of the interpretations of the trust loss measures contained in the accompanying Explanatory Memorandum as they now apply to the proposed definition of "fixed trust" are unlikely to be upheld by a Court. Effectively, the Explanatory Memorandum established the Commissioner's administrative practice as opposed to explaining the operation of the legislation as drafted.[1] These issues were also canvassed in a number of submissions made at the time. We would be happy to provide copies if you require.

Suggestion:

It is important to ensure that these issues should be carefully considered in the drafting of the definition of "fixed trust" to ensure that the legislation reflects the Commissioner's current administrative practice.

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[1] Many of these concerns are dealt with later in this submission. They are also the subject of a number of papers written on the issue including:

- *Trust Losses* by Richard Gelski presented at the TIA Qld Annual State Taxation Convention, 31 May 1997.

- *"Trust Losses – Where are they Now?* by Peter Riley presented at a TIA Seminar in Hobart on 7 March 1997.

2.2 Market value requirement

Issue:

Section 272-5(2) of the 1936 Act effectively imposes a market value rule for allotments of new units, that is for a fixed entitlement to a share of income or capital of a trust to exist, units in a unit trust must be allocated for market value. In many public unit trusts there is a dividend reinvestment plan in place with the consequence that units issued by that trust may be issued at a discount to market. As a result, that unit trust will not satisfy the market value requirement and hence will not be a fixed trust. Moreover, many unit placements can only occur commercially at some discount to market.

Suggestion:

There are a number of alternative ways in which this situation could be remedied. Because the market value rule is commercially not realistic in the market place, it may be more appropriate to either:

- substitute the test with an arm's-length test; or
- retain the market value test, but make it subject to a maximum commercially realistic discount of (say) 15% to fair market value.

2.3 Securitisation vehicles

Issue:

It is not uncommon to securitise an income stream by establishing unit trusts that issue fixed units to institutional investors, usually with very high monetary value attached to them ie. non-retail investors, and for the manager of the trust to hold a residual unit in the trust which gives the trust manager a right to any residual income or capital of the trust, after paying the fixed obligation to the institutional investors. The residual income distribution of the trust therefore sweeps any non-allocated income to the manager. The distribution to the trust manager usually represents an alternative to the payment of fees for management services.

These securitisation vehicles, with more than 1 class of unit, including the residual unit, may constitute a NFT for the purposes of the entity taxation measures as the entitlement of the respective unit-holders vary.

Although there may be two classes of units, each class of units has a fixed entitlement to income of the unit trust ie. the unit-holders have a fixed entitlement based on a specific formula, and the residual unit-holder has a fixed entitlement to the remaining income, if any, in the trust. In addition, the trustee usually has no discretion in how to distribute income of the trust. On this basis, we consider that such vehicles should constitute fixed trusts for the purposes of the entity taxation measures.

Suggestion:

The definition of a "fixed trust" should cover and include securitisation trusts. Due to the important commercial significance of such vehicles, uncertainty and ambiguity in this area is unsatisfactory.

2.4 Employee share plans

Issue:

Employees share plan schemes are also hurt by the proposed definition of fixed trust. Trusts have been a popular device for employee share schemes as they have often deliberately prevented a full vesting of interest in shares until required milestones have been met: this protects the company and ensures that the employee remains for the pre-agreed minimum period over which the scheme operates, thereby creating mutual incentives for both the company and the employee. Where the milestones are not met or the employee leaves inside the pre-determined period, it is not unusual for the employee's entitlement to be terminated at that point in time.

Accordingly, it is clear that there will be many employee share plans utilising trust arrangements whereby the employee will not have a fixed entitlement to the shares during the currency of the trust.

Moreover, it is also not unusual for shares to be allotted to the employee at a discount to market. Hence, there is another basis on which the trust would fail the fixed trust requirements. If the employee share plan trust was to be taxed as a fixed trust, then many of the perceived benefits of the employee share scheme may be eroded. Clearly, from a policy perspective, having regard to the recently released report, 'Shared Endeavours: Inquiry into Employee Ownership in Australian Enterprises' issued by the House of Representatives Standing Committee on Employment, Education and Workplace Relations, employee share plans should be encouraged.

Suggestion:

The recommendation is to have an employee share plan trust treated as an 'excluded trust' and therefore as one to which Division 6 of the 1936 Act continues to operate.

2.5 Loyalty trusts

Issue:

Loyalty programs usually involve members earning reward points for transactions related to a retailer's services or products. These programs are usually structured through a trust structure and will generally involve a finance company and the retailer.

For similar reasons to those applying to employee share acquisition plans, it appears that many of these trusts may be NFTs. As a result, these loyalty programs will be subject to differential tax treatment. In addition, if the trust is a NFT, members will be taxed when they redeem their "loyalty points". Such tax treatment may threaten the viability of such programs.

Suggestion:

The recommendation is to have a 'loyalty trust' treated as an 'excluded trust' and therefore as one to which Division 6 of the 1936 Act continues to operate.

2.6 Venture capital funds

Issue:

A key feature of the structure of venture capital funds involves the manager being allotted special classes of the units. These units have no entitlement to distributions until the fund has met minimum performance requirements. This usually involves ensuring that the investors have at least received a minimum return.

From a policy perspective, it would seem that venture capital funds would not be attractive unless they can retain flow through taxation.

Suggestion:

We acknowledge that finding an appropriate definition of 'venture capital fund' may be difficult. However, assuming that it is possible to satisfactorily define 'venture capital fund', such funds should be treated as excluded trusts for the purposes of the NFT regime.

2.7 Fund managers discretionary powers over taxable income

Issue:

Paragraph 2.11 of the Explanatory Material suggests that a trust is not a fixed trust if some part of income or capital of the trust may be distributed at the discretion of the trustees/manager. The exact operation of this provision is unknown at this stage.

Many trust managers have the right to determine the level of distributable income, which theoretically may cause the trust to be treated as a non-fixed trust if the trust manager so determines the level of distributable income.

It is submitted that such a rule should not operate in the context of a public listed trust or a widely held retail or wholesale trust. In particular, unit holders may have adequate consumer protection through the relevant trust being regulated by the Managed Investments Act.

Suggestion:

This rule should not be applied to deem the trust to be a non-fixed trust where unit holders have fixed entitlements to all of the distributable income of the trust and the trust manager merely determines the amount of that distributable income.

2.8 Restructure relief

Issue:

It may be some time until the definitions of ‘fixed trust’ and ‘non-fixed trust’ are available. It is likely that a number of trustees will seek to amend their trust deeds to put beyond doubt that their trust is clearly a ‘fixed trust’. The process of amending a trust deed is very time consuming and it is likely that many will not be able to complete that process by 1 July 2001.

In addition, the necessary changes to a trust deed may result in a resettlement of the trust asset.

Suggestion:

Consideration be given to allowing more time for trusts that elect to be treated as a ‘fixed trust’ to undertake the necessary changes to their trust deeds provided that they do not undertake any distribution inconsistent with their ‘fixed trust’ status.

Further, consideration be given to providing restructure relied along the lines of that provided under the Managed Investments Act – that is that if the restructure has resulted in a resettlement, such resettlement is deemed not to have occurred for tax purposes.

3 Distributions

Issue:

The use of the term “entitlement” raises other issues. “Entitlement” is a different legal concept from “distribution”. There will be times when a member will be presently entitled, under trust law, to a share of income or capital of a NFT but no distribution will have been made for tax purposes and vice versa (refer to section 156-20 of the Exposure Draft). The main practical issue that will arise here is determining the timing of when a distribution is taxable for tax purposes.

When a trustee makes a “trust distribution”, that is the trustee confers income and/or corpus of the trust exclusively in favour of a particular beneficiary, the beneficiary becomes vested and indefeasibly entitled to that income and/or corpus. This will constitute a “distribution” as defined under the Exposure Draft. Issues arise where the trustee does not settle such “trust distribution” by way of a transfer of property at the same time. Where settlement of an earlier “trust distribution” occurs, the settlement or property transfer, will also be captured by the very broad definition of “distribution” within the Exposure Draft.

Suggestion:

The definition of “distribution” contained in the Exposure Draft should capture all “trust distributions” and should also exclude any transfers of property made in settlement of a “trust distribution” that has been previously captured as a “distribution” under the legislation.

Amendments are also required to clarify timing of derivation by a beneficiary of a NFT distribution.

4 Irrevocable classification as a non-fixed trust

Issue:

Section 153-25(2) of the Exposure Draft effectively provides that if a trust is a NFT in one income year of the trust, it will be effectively treated as a NFT for all subsequent income years. This is a very harsh test. This ‘once and for all’ type of test has not been adopted elsewhere in the Income Tax Assessment Act. For example, Division 6C of the 1936 Act looks to see if a trust is a public trading trust on year by year basis.

The key concern here is that, having regard to the uncertainty surrounding the definition of a fixed trust, it is possible that a trust could unintentionally become a NFT. Many unit trusts instruments establishing a trust used as collective investment vehicle contain clauses that may result in the trust being classified a NFT as currently defined. For example:

- the trust instrument may confer on the trustee a discretion to determine distributable income;

- a unit holder’s entitlement to income may be determined after year end, and / or

- a trust instrument may be capable of amendment in a way that impact on the member’s rights to income or capital.

There are many more examples. It is essential to ensure that the mere existence of such provisions will not result in a classification of that unit trust as a NFT.

Suggestion:

Rather than have the ‘once and for all’ type of test, the suggestion is that the proposed test look to the actual performance of the trust for any given year. In other words, if ‘at all times during the relevant year of income’ the trust behaved as a fixed trust, then the trust should be taxed as a fixed trust for that year of income. If, however, ‘at any time’ during the year of income the trustee exercised a discretion to vary the traditional distributions of income or capital to beneficiaries, then the trust would be treated as a NFT for the whole of that year of income.

5 "Available profits"

Issue:

"Available profits" is a key concept in the application of the distribution rules. It is defined in section 157-80 of the Exposure Draft to include the unrealised gains on assets. This inclusion of unrealised gains (through the reference in that section to "net market value of assets") is that it effectively subjects unrealised profits to taxation. This ignores the fact that such profits are not available to a NFT until the asset is realised. This accelerates the taxation of such income in the sense that the beneficiary will be assessed on an amount in respect of which the trust itself is not taxable.

As the income is unrealised and untaxed in the "hands of" the NFT, no imputation credits will be available upon a distribution sourced to those profits. Moreover, once the profit is realised, it would then enter the accounting profit of the trust (and be taxed at the trust level) which, on actual distribution, would be assessable again to the beneficiary, albeit franked. In other words, there is no tiebreaker clause to prevent effective double taxation at the beneficiary level.

Suggestion:

"Available profits" should not include unrealised profits or unrealised losses.

Issue:

An area of potentially significant unrealised profits will be in the area of goodwill. For example, a dot.com start up business may be in losses for several years before going into times of significant profitability. With hindsight, the goodwill of this business could be given a higher value in the early years of operation than would have actually been given at the time. Accordingly, to protect the NFT against the potential impact of such retrospective revaluations it will be necessary to regularly value goodwill on an on-going basis. This will significantly increase the compliance costs for such businesses especially in their critical start up phase.

Suggestion

Goodwill should be excluded from the "available profits" calculation in section 157-85 of the Exposure Draft .

Issue:

All CGT exempt assets that were in discretionary trusts prior to November 1999 should be treated as an exception to the "profits first" rule under Sub-division 157-C of the Exposure

Draft. As currently draft, sections 157-35-157-55 do not exclude all exempt CGT assets. For example, Pooled Development Funds are exempt because of section 118-13. It is unfair that the benefit of the exemption is lost through the operation of the 'profits first' rule.

Suggestion:

All CGT exempt assets should be excluded from the calculation of 'available profits' for the 'profits first' rule.

6 Pre-CGT assets

Issue:

The rules relating to pre-CGT assets in relation to the determination of a NFT's contributed capital balance impose significant and unrealistic compliance requirements. The NFT must have records of acquisition dates and costs for all pre-CGT assets. Many trusts subject to the NFT rules will have held assets (eg a family farm) for generations. The original cost and the cost of additions and improvements over such a long time period will not have been recorded. If these details cannot be substantiated then no value is allocated to such assets. This is both unjust and unreasonable.

Moreover, the operation of the profits first rule in the context of unrealised gains on assets being included in the profit calculation means that there is a possibility that an unrealised capital gain on a pre-CGT asset could be deemed to be profit which, on distribution to a beneficiary, will be taxable to the beneficiary. Clearly, this is inappropriate.

Suggestion:

Pre-CGT assets should be treated as a separate category.

Rather than have the significant compliance costs relating to pre-CGT assets with the purpose of calculating 'contributed capital', it would be simpler if the distribution of proceeds on disposal of pre-CGT assets were simply deemed to be not assessable (and also specifically deemed not to be exempt income) in the hands of the beneficiary.

If the 'available profits' calculation is to retain unrealised gains or losses, then unrealised gains on pre-CGT assets should be specifically excluded from that calculation.

7 "Contributed Capital"

Issue:

Generally, members of a discretionary trust do not contribute capital to the trust. Also, where there is a resettlement of a trust with all the assets of one trust contributed to another, there is no member who made the contribution. Accordingly, no amount is credited to a member's contributed capital account. It appears that any subsequent distribution of this amount will be taxable under the CGT provisions as the member had no cost base in such contributed capital.

Suggestion:

Any contributed capital received by a member should be tax-free and should be deemed not to be exempt income.

Alternatively, such contributed capital could be allocated by way of an irrevocable resolution of the trustee to the members and be notionally contributed into their contributed capital account. Conversely, such allocated amount should also be deemed to be that member's CGT cost base of his or her "membership interest"

8 Interaction with section 104-70 of the 1997 Act

Issue:

Under the Exposure Draft legislation, a trust will still receive the benefit of the 50% capital gains tax discount but, in many cases, it will not be able to fully pass the benefit of this concession to its beneficiaries .

For example, where a trustee of a trust generates a $100 capital gain, it will be subject to $15 tax. This tax payment will enable the trustee to distribute $35 of that gain fully franked. The remaining $50 is also available for distribution but there will not be any corresponding franking credit available. As in many cases the beneficiary will not have a cost base for their trust interest, under section 104-70 of the 1997 Act, the whole $50 will be an assessable capital gain. As a result, the benefit of the 50% capital gains tax concession is not passed on to the beneficiary.

Suggestion:

The distribution that represents a concessionally taxed capital gain should be tax free. It should not be exempt income. Accordingly it will not be necessary to add it to contributed capital.

9 Impact of the 45 day rule

Issue:

A beneficiary of a discretionary trust that holds shares in a company may not have a sufficient ownership interest in the shares of that company to be able to satisfy the 45-day rule. Accordingly, it would appear that the beneficiary will not be able to receive imputation credits from that company or the trust. Further, the beneficiary will not be able to have the benefit of a credit for tax paid by the company or the trust. The way to solve this is for the trust to make a family trust election – this is forcing every trust to make a family trust election. However, this is not available to a trust that is not a family trust, eg. a widely held listed, retail or wholesale trust.

Suggestion:

The 45-day rule should not apply to distributions by a NFT.

10 Loans

Issue:

We require confirmation that if a NFT repays a commercial loan or a loan from another NFT or a company, no distribution arises under the basic rule at section 156-20 of the Exposure Draft. While section 156-105 outlines that payments discharging pecuniary obligations are not taken to constitute distributions under section 156-75 there appears to be no mechanism to ensure that such a repayment is not a distribution under the basic rule.

If a distribution does arise in these circumstances is it the case that the value of the distribution is nil as the reduction in the pecuniary obligation constitutes the consideration provided to the trust for the amount distributed?

A loan out of profits, if it is non-arm's length will be assessable. The rules as they now apply make loans assessable to beneficiaries. If a loan is simply a trust distribution to a beneficiary that was assessed under section 97, there is no mischief and that loan should be excluded from these provisions. There should be a special calve out.

Suggestion:

As a transitional measure, all loans (including unpaid trust distributions) before the start date of this legislation should not be subject to the commercial loan rules.

11 Discriminatory approach to NFTs

Issue:

A key plank of *A New Tax System*, as announced by the Treasurer in August 1998, was the consistent taxation treatment of various entities, including discretionary and fixed trusts, like companies. In addition to the consistent treatment of different entities, it was also proposed to apply a consistent tax treatment to all distributions by all such entities to their members. The "profits first" rule was one of the key rules proposed to meet this objective.

It is unclear how this rationale for the introduction of the "profits first" rule to all entities supports its application to NFTs only. It has been suggested that the mandatory application of the "profits first" rule to NFTs merely replicates the rules currently applying to corporate entities. In fact, it goes a lot further than the anti-avoidance provisions contained in sections 45 to 45C of the 1936 Act.

Companies are able to distribute capital to shareholders without the distribution being taxed as a dividend subject to the operation of the anti-avoidance provision contained in sections 45 – 45C of the 1936 Act. The effect of these provisions is that capital can be so distributed where the distribution is, in effect, not in substitution of a dividend. This would not be the case if a "profits first" rule applied to companies.

Sections 45 and 45A are anti-avoidance provisions in relation to streaming arrangements, and not relevant when comparing the position of companies to the proposed position for NFT's. Further, section 45B is an anti-avoidance provision that depends whether a tax advantage arises. Thus, unlike the mandatory application of the "profits first" rule to NFT's, a company may distribute its capital to shareholders if it passes section 45B.

Companies remain in an advantageous position when compared to NFT's with respect to achieving capital distributions. Under the proposed "profits first" rule, NFT's have no opportunity to return capital to their members, other than where no profits exist, or, on extinguishment of the membership interest. Furthermore, practically, unlike companies, while undistributed realised and unrealised profits exist, a discretionary trust cannot distribute capital to its members, other than on dissolution of the trust.

Suggestion:

Distributions by NFT's should not be subject to a different tax treatment from that applying to companies. NFT's should not be subject to the "profits first" rule. If the intended policy outcome is that NFT's are to be taxed consistently with companies, the same dividend substitution anti-avoidance rules that currently apply to companies could apply to NFT's.