

A more workable approach for fixed trusts

Discussion Paper
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CONSULTATION PROCESS

Request for feedback and comments

The Government seeks your feedback and comments on the issues outlined in this consultation paper. The information obtained through this process will inform the Government's approach on the way forward and also assist in meeting the requirements of the Office of Best Practice Regulation.

While submissions may be lodged electronically or by post, electronic lodgement is preferred. For accessibility reasons, please email responses in a Word or RTF format. An additional PDF version may also be submitted.

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Closing date for submissions: 14 September 2012

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FOREWORD



The decision of the Federal Court in *Colonial First State Investments Limited v Commissioner of Taxation* confirms that many trusts need to rely on the Commissioner of Taxation to exercise a discretion to be considered as a 'fixed trust'. This is an issue for publicly listed trusts, such as managed investment trusts (MITs), as well as private trusts. The need for the exercise of a discretion has caused a number of taxpayers, including a large number of MITs, to suggest that the current definition of fixed trust is unduly restrictive. In response to these concerns the Government announced in November 2011 that it would consult on the appropriateness of the current definition of fixed trust, with a view to developing a more workable approach.

I am pleased to release this paper which is the next step in the Government's agenda to increase certainty in the taxation of trust income and reduce compliance costs for taxpayers. The paper presents a number of options to address the uncertainty, and considers avenues to provide a balance between the practicalities of allowing trusts to function efficiently and maintaining the integrity of the law. In particular, the paper considers options that could ensure that stakeholders are able to satisfy the definition of fixed trust under the ordinary provisions of the law without relying on the Commissioner's discretion.

Consultation plays a valuable role in developing policy to guide changes in the tax law. The paper poses a number of questions which are designed to focus attention on the ability of the law to achieve fair and appropriate outcomes. I look forward to receiving stakeholders' views on any one or more of the questions in the paper or any other matter relevant to the definition of fixed trust.

A handwritten signature in black ink, appearing to read 'David Bradbury'.

The Hon David Bradbury MP
Assistant Treasurer

ABBREVIATIONS

ATO	Australian Taxation Office
Board	Board of Taxation
Corporations Act	<i>Corporations Act 2001</i>
CGT	capital gains tax
Commissioner	Commissioner of Taxation
Income tax laws	the ITAA 1936, the ITAA 1997 and the TAA 1953
ITAA 1936	<i>Income Tax Assessment Act 1936</i>
ITAA 1997	<i>Income Tax Assessment Act 1997</i>
MIT	managed investment trust
TAA 1953	<i>Taxation Administration Act 1953</i>

OVERVIEW

Concerns about the taxation of trust income have been raised in a number of contexts over the last 20 years. These concerns include the tax treatment of fixed trusts and, in particular, the narrowly construed definition of ‘fixed trust’.

In practice, very few trusts will qualify as a fixed trust unless the Commissioner of Taxation exercises the limited discretion to treat a trust as a fixed trust. This creates uncertainty and complexity for taxpayers and means that taxpayers and the Australian Taxation Office incur compliance and administrative costs in preparing and responding to applications to treat a trust as a fixed trust.

This discussion paper examines the definitions of ‘fixed trust’ and its related terms ‘fixed entitlement’ and ‘vested and indefeasible’. The term ‘fixed trust’ is particularly important because it is used to determine how certain provisions of the income tax laws¹, such as the carry forward loss rules, apply.²

The paper considers a number of options for developing a more workable approach for fixed trusts. One option is to use a ‘clearly defined rights test’, similar to the one discussed in the context of MITs. However, there are a number of other options and it may be appropriate to tailor the approach taken to the particular use of the fixed trust concept.

Any change to the definition of ‘fixed trust’ is likely to impact on the many provisions that use this term (as set out in the Attachment). However, it may have a much broader effect as different provisions and concepts are picked up elsewhere in the legislation. The extent of the impact of the change will depend on the nature of any reforms that are implemented.

The Government has made no decisions on the questions raised in this discussion paper. Feedback from stakeholders will inform the Government on how these terms could be clarified so as to provide certainty and ensure consistency in their application.

1 That is, the *Income Tax Assessment Act 1997* (ITAA 1997), the ITAA 1936 and the *Tax Administration Act 1953* (TAA 1953).

2 Schedule 2F to the *Income Tax Assessment Act 1936* (ITAA 1936).

1. RELATIONSHIP BETWEEN 'FIXED TRUST' AND 'INDEFEASIBLE'

A recent Federal Court decision has confirmed that the definition of 'fixed trust' in the income tax laws is perhaps narrower than understood by trustees and their advisors.³ In particular, the Court found that the requirement that the rights of beneficiaries be 'indefeasible' (cannot be defeated) is very difficult to meet. This is because the Court considered that powers created by statute as well as by the trust deed may result in the rights of the beneficiaries not being 'indefeasible'.

This Chapter looks at the definition of 'fixed trust' for the purposes of Australia's income tax laws and its relationship with the term 'indefeasible'. The Commissioner of Taxation's (Commissioner's) limited discretion to treat a trust as a fixed trust is outlined and the terms 'vested' and 'indefeasible' are explained along with the reasons that make the 'indefeasible' test difficult to satisfy. This Chapter also identifies some of the other terms and provisions that rely on the 'indefeasible' concept.

1.1 MEANING OF 'FIXED TRUST'

A trust is a fixed trust if entities have fixed entitlements to all of the income and capital of the trust. The definition is included in largely the same terms in both the *Income Tax Assessment Act 1997* (ITAA 1997)⁴ and the *Income Tax Assessment Act 1936* (ITAA 1936)⁵. The term 'fixed trust' is used throughout the income tax laws.

Question1:

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

1.2 MEANING OF 'FIXED ENTITLEMENT'

Broadly, a beneficiary has a fixed entitlement to the income or capital of a trust if they have a vested and indefeasible interest in the income or capital of the trust.⁶ The definition expressly provides that the power to redeem existing units or issue additional units in a unit trust by reference to their listed price or the trust's net asset value will not mean that the interest is defeasible.⁷

There are a number of nuances to the basic definition. For example, the interest must be 'under a trust instrument' and it must relate to the income of the trust that the trust 'derives from time to time'. The requirement that the interest arise 'under a trust instrument' arguably excludes constructive trusts, resulting trusts and trusts arising by oral declaration. This may reflect the uncertainty surrounding a trust where the terms are not clearly set out in writing. The Commissioner may still be able to exercise the discretion to allow the trust to be treated as a fixed trust. However,

3 *Colonial First State Investments Limited v Commissioner of Taxation* [2011] FCA 16.

4 Subsection 995-1(1) of the ITAA 1997.

5 Section 272-65 in Schedule 2F to the ITAA 1936.

6 Subsection 272-5(1) in Schedule 2F to the ITAA 1936.

7 Subsection 272-5(2) in Schedule 2F to the ITAA 1936.

it may not be appropriate for such trusts to be excluded from the basic definition if the terms of the trust have been settled by a court.

Question 2:

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

1.2.1 Commissioner's discretion

A beneficiary has a fixed entitlement if the Commissioner considers that they should, having regard to:

- the circumstances in which the entitlement is capable of not vesting or the defeasance can happen;
- the likelihood of the entitlement not vesting or the defeasance happening; and
- the nature of the trust.⁸

The Commissioner's discretion is intended to provide for circumstances where, despite the trust not technically meeting the requirements to be a 'fixed trust', the likelihood of the beneficiary's vested interest being defeated is low, and it would be unreasonable in the context of the statutory scheme to treat the beneficiary's interest as not constituting a 'fixed entitlement'.⁹

For example, it is to be expected that it would only be in exceptional circumstances that the Commissioner would not exercise the discretion to treat a listed unit trust whose units are quoted and traded on the Australian Securities Exchange (ASX), and are therefore subject to the *Corporations Act 2001* (Corporations Act), which provides a power to amend the constitution and the ASX Listing Rules, as a fixed trust.

While the Commissioner's discretion to deem a beneficiary to have a fixed entitlement to income or capital provides an effective fall back for some trusts that would not otherwise meet the definition of a 'fixed trust', the intent is that the discretion should not be the primary means by which it is determined whether a trust is a fixed trust. Over-reliance on the Commissioner's discretion would add considerably to uncertainty and increase compliance and administration costs. Moreover, over-reliance on the discretion is contrary to the statutory scheme in which the discretion was intended to have a narrow targeted function by way of a saving provision rather than a broad reach.

1.3 MEANING OF 'VESTED AND INDEFEASIBLE'

The terms 'vested' and 'indefeasible' are not defined in the tax law and (subject to statutory modifications in some cases)¹⁰ take the meaning they have developed through case law.

⁸ Subsection 272-5(3) in Schedule 2F to the ITAA 1936.

⁹ Explanatory Memorandum, Taxation Laws Amendment (Trust Loss and Other Deductions) Bill 1998, paragraph 13.13.

¹⁰ For example, subsection 272-5(2) in Schedule 2F to the ITAA 1936 provides that the mere fact that units are redeemable, or that further units are able to be issued, does not mean that the person's interest is defeasible.

Whether an interest in a trust is 'vested' and 'indefeasible' is generally determined by examining the terms of the trust instrument. Most commonly a trust instrument will be a trust deed, constitution or will. However, there are circumstances in which the trust instrument must be read subject to the operation of other statutes, such as the Corporations Act.

1.3.1 Vested

The meaning of 'vested' was summarised in the Explanatory Memorandum to the Taxation Laws Amendment (Trust Loss and Other Deductions) Bill 1998, which introduced the definition of 'fixed trust' to the income tax laws, as follows:

Simply stated, a vested interest is one that is bound to take effect in possession at some point in time.¹¹

A vested interest may be vested *in possession*, that is, with the beneficiary enjoying a presently existing right to enjoyment, or it may be vested in *interest*, that is, where the beneficiary instead has a presently existing right to *future* enjoyment.¹²

A vested interest is to be contrasted with a contingent interest which may never fall into possession.¹³ A contingent interest gives no rights at all unless or until some future event (the contingency) takes place. An example of a contingent interest might be a beneficiary's entitlement to income which is expressed under the deed only to arise if the trustee exercises a power of appointment in favour of the beneficiary.

1.3.2 Indefeasible

An interest is indefeasible where it cannot be terminated, invalidated or annulled.¹⁴ In contrast, an interest is defeasible if it can be brought to an end or defeated, in whole or in part, by the operation of a condition subsequent or conditional limitation.¹⁵ If an interest of a beneficiary can be taken away by the exercise of a power by the trustee or another person it is defeasible and will not meet the definition of a 'fixed entitlement'.¹⁶ For example, if a deed gives a beneficiary (the default beneficiary) an interest in income which may be defeated by the trustee appointing income in favour of a different beneficiary, the default beneficiary's interest is vested but defeasible.

The focus of the test is not whether the interest has been defeated but whether it is capable of being defeated.

The decision in *Colonial First State Investments Limited v Commissioner of Taxation* [2011] FCA 16 (*Colonial*) confirmed that an interest will be defeasible if the power to defeat the interest arises from statute or the trust instrument. The decision confirms the concern that very few trusts can, in practice, satisfy the definition of a 'fixed trust' in the absence of the exercise of the Commissioner's

11 Explanatory Memorandum to the Taxation Laws Amendment (Trust Loss and Other Deductions) Bill 1998, paragraph 13.4.

12 Explanatory Memorandum to the Taxation Laws Amendment (Trust Loss and Other Deductions) Bill 1998, paragraph 13.5.

13 Explanatory Memorandum to the Taxation Laws Amendment (Trust Loss and Other Deductions) Bill 1998, paragraph 13.4.

14 *Colonial First State Investments Limited v Commissioner of Taxation* [2011] FCA 16, paragraph 97.

15 *Walsh Bay Developments Pty Ltd & Anor v FC of T* 95 ATC 4378 at 4389.

16 Explanatory Memorandum to the Taxation Laws Amendment (Trust Loss and Other Deductions) Bill 1998, paragraph 13.7.

discretion. This is because beneficiary entitlements are very commonly able (at least theoretically) to be defeated by the exercise of a power in the trust instrument or by a statutory power.¹⁷

Further discussion of the rights and powers that may be consistent with treating an interest as a fixed entitlement for the purposes of determining whether there is a fixed trust is in Chapter 2.

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?

1.4 RELATIONSHIP WITH OTHER PROVISIONS OF THE TAX LAW

As set out above, some trusts have difficulty meeting the definition of ‘fixed trust’. In particular, they have difficulty demonstrating that the beneficiaries have ‘fixed entitlements’ because the ‘indefeasible’ test (for the purposes of determining ‘fixed entitlement’) is difficult to meet. However, changing the meaning of any of these terms, that is, fixed trust, fixed entitlement or indefeasible, is likely to have flow on effects throughout the income tax laws. Various provisions that directly use the term ‘fixed trust’ are summarised in the Attachment.

The definitions of some other terms directly use the term ‘fixed trust’. These terms include ‘closely held trust’,¹⁸ ‘non-fixed trust’,¹⁹ ‘excepted trust’²⁰ and ‘widely held unit trust’.²¹ These terms, and the provisions that they are used in, are then picked up indirectly in different parts of the income tax legislation. As such, the term ‘fixed trust’ impacts on many more parts of the income tax laws than is identified in the Attachment and any change to the term ‘fixed trust’ will also impact on those other provisions.

Similarly, a number of provisions use the term ‘indefeasible’. The term ‘indefeasible’ is used directly in the definitions of ‘fixed entitlement’,²² ‘fixed interest’,²³ ‘instalment income’²⁴ and ‘IRU’.²⁵ The term ‘indefeasible’ is also used directly in the provisions summarised in the table below.

Provision	Context
Section 78A ITAA 1936	Certain gifts not deductible if receipt not indefeasible

17 ATO Decision Impact Statement, *Colonial First State Investments v Commissioner of Taxation*.

18 Section 102UC of the ITAA 1936.

19 Defined in subsection 995-1(1) of the ITAA 1997 as a trust that is not a fixed trust.

20 Section 272-100 in Schedule 2F to the ITAA 1936.

21 A widely held unit trust must be a fixed trust: subsection 272-105(1) in Schedule 2F to the ITAA 1936. The concept of a widely held unit trust is then picked up as part of the definition of notions of unlisted widely held, listed widely held and unlisted very widely held trusts (see Subdivisions 272-G and 272-H of Schedule 2F).

22 Section 272-5 in Schedule 2F to the ITAA 1936.

23 Section 207-128 of the ITAA 1997.

24 Section 45-280 in Schedule 1 to the TAA 1953.

25 Being an indefeasible right to use a telecommunications cable system: see subsection 995-1(1) of the ITAA 1997.

Provision (continued)	Context (continued)
Section 95A ITAA 1936	Deems a person to be presently entitled to an amount where they have a vested and indefeasible right to the amount
Section 30-220 ITAA 1997	Deduction for gifts reduced by reasonable amount if not indefeasible
Section 207-122 ITAA 1997	Ineligibility for franking credits if a distribution is made to an entity in a form of property other than money where the entity does not obtain an immediate indefeasible and unencumbered legal and equitable title to the property

As with the term ‘fixed trust’, the definitions and other provisions that use the term ‘indefeasible’ may be picked up indirectly elsewhere in the legislation in a range of contexts.

All of the provisions that use the term indefeasible, directly or indirectly, may also be affected by the decision in *Colonial* and the narrow definition of ‘indefeasible’. These provisions will not be considered in detail here because this paper is focussed on the definition of ‘fixed trust’.

However, the options for providing a more workable approach to fixed trusts include modifying or removing the references to ‘fixed entitlement’ or ‘indefeasible’. As such, it is appropriate to consider how the definition of ‘indefeasible’ and ‘fixed entitlement’ (as set out in *Colonial*) impacts on these terms and the potential flow-on effects of a change to the definition.

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’)?

2. REFORM OPTIONS

This Chapter considers options that could provide a more workable approach to the definition of ‘fixed trust’. It examines the ‘clearly defined rights’ test which was identified as an alternative to requiring MITs to satisfy the ‘vested and indefeasible’ requirement before receiving fixed trust treatment. This Chapter also considers the possibility of designing different tests for different purposes. Some options that might be appropriate in relation to particular provisions are also examined.

2.1 THE ‘CLEARLY DEFINED RIGHTS’ TEST

2.1.1 Background to the ‘clearly defined rights’ test

The Government has already considered circumstances where it might be appropriate to provide fixed trust treatment for entities that might otherwise not qualify.²⁶ The Board of Taxation (Board) has recommended that MITs with ‘clearly defined rights’ be deemed to be a ‘fixed trust’ for income tax law purposes as this would provide an appropriate balance between integrity and access to the relevant tax treatment. It may be appropriate to adopt this approach, or a similar approach, in relation to trusts more generally.

In this context, it is important to note that MITs are widely held collective investment trusts that pool funds from investors to undertake largely passive investments.²⁷ The nature of MITs as widely held entities subject to various regulatory oversight mechanisms provides additional integrity to the proposal to provide them with fixed trust treatment. As such, the options proposed for MITs may not be appropriate for all trusts or in all contexts.

The Government agreed to the Board recommendation in principle, with the design details including appropriate integrity rules to be developed as part of the new tax system for MITs. However, it was not proposed that the unit holders or beneficiaries of MITs would be treated as having ‘fixed entitlements’ or otherwise ‘indefeasible’ rights.

2.1.2 Implementing the ‘clearly defined rights’ test: the ‘no material discretionary elements’ test

The discussion paper, *Implementation of a New Tax System for Managed Investment Trusts* considered options for implementing the ‘clearly defined rights’ requirement.²⁸ In particular, the paper considered using a ‘no material discretionary elements’ approach based on Subdivision 126-G of the ITAA 1997.²⁹ The paper also considered that it may be appropriate to treat some MITs as automatically satisfying this test.

26 In relation to its response to the Report *Review of the Tax Arrangements Applying to Managed Investment Trusts*. The Board’s Report is available at:
http://www.taxboard.gov.au/content/content.aspx?doc=reviews_and_consultations/managed_investment_trusts/default.htm&pageid=007.

27 The current definition of ‘managed investment trust’ is in section 12-400 of Schedule 1 to the TAA 1953. The definition is extended in Subdivision 12-H in Schedule 1 to the TAA 1953.

28 Available at: <http://archive.treasury.gov.au/contentitem.asp?NavId=037&ContentID=1878>, see paragraph 25-42.

29 Subdivision 126-G of the ITAA 1997 provides a CGT roll-over for the transfer of assets between ‘fixed trusts’. These trusts are not required to meet the definition of ‘fixed trust’ in Schedule 2F to the ITAA 1936.

The key to allowing access to ‘fixed trust’ treatment using a ‘no material discretionary elements’ test, is to determine what types of discretions are consistent with treatment as a fixed trust. The test looks to the discretions of the trustee rather than the interests of the beneficiary.

The test is largely principle-based in that it will be met if the manner or extent to which each beneficiary of each trust can benefit from the trust is not capable of being significantly affected by the exercise or non-exercise of a power.³⁰ In determining whether the test is met, a power that does not significantly affect the market value of each membership interest in the trust if both trusts are MITs can be disregarded.³¹ The test leaves some flexibility as to which powers might be seen as ‘material’.

However, it should be noted that the context of the provision provides additional limitations. For example, for the ‘no material discretionary elements’ test to apply, all of the beneficiaries must have interests in the trust.³² As a result, the trust cannot be a discretionary trust because the beneficiaries of a discretionary trust do not have a relevant interest in the trust.³³ In addition, under the proposed MIT rules, the rights would need to be set out in the trust’s constituent documents.

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?

For the purposes of the ‘no material discretionary elements’ test, a power includes trust powers (powers that must be exercised but which allow discretion as to when or how they are exercised); mere powers (powers that can, but do not have to, be exercised); and powers of the appointor who directs a trustee. A power does not, however, include a trustee’s duties being something a trustee must do as prescribed, or refrain from doing, to avoid being in breach of trust.³⁴

Powers which are merely administrative in nature and do not significantly affect the manner or extent to which a beneficiary can benefit from a trust should not result in a trust being treated as non-fixed. These include a power to:

- round distributions or other amounts to whole cents per unit or interest;
- alter the manner in which beneficiary entitlements are paid, for example, to determine that they may be credited directly to beneficiaries’ bank accounts; and
- pay beneficiary entitlements at any time within a prescribed period.

30 Subsection 126-230(3) of the ITAA 1997.

31 Subsection 126-230(4) of the ITAA 1997.

32 Subsection 126-230(2) of the ITAA 1997.

33 Tax Determination TD 2003/28 available at:

[http://law.ato.gov.au/atolaw/view.htm?dbwideocone=06%3AATO%20Rulings%20and%20Determinations%20\(Including%20GST%20Bulletins\)%3ABY%20Type%3ADeterminations%20\(Including%20GST%20Bulletins\)%3ATaxation%3A2003%3A%2304970280000%23TD%202003%2F28%20-%20Income%20tax%26c%20capital%20gains%26c%20does%20CGT%20event%20E4%20in%20section%20104-70%20of%20the%20Incom...%3B](http://law.ato.gov.au/atolaw/view.htm?dbwideocone=06%3AATO%20Rulings%20and%20Determinations%20(Including%20GST%20Bulletins)%3ABY%20Type%3ADeterminations%20(Including%20GST%20Bulletins)%3ATaxation%3A2003%3A%2304970280000%23TD%202003%2F28%20-%20Income%20tax%26c%20capital%20gains%26c%20does%20CGT%20event%20E4%20in%20section%20104-70%20of%20the%20Incom...%3B)

34 Heydon, J. D. and Leeming, M.J. (2006) *Jacobs’ Law of Trusts in Australia*, 7th ed., Sydney, Butterworths at [1606].

Similarly, a trustee's right to be reimbursed out of trust property in respect of expenses incurred in administering the trust should not, generally, be seen as significantly affecting the manner and extent to which a beneficiary can benefit from a trust.

By contrast, if the powers are capable of significantly affecting the manner and extent to which a beneficiary can benefit from the trust, it is not appropriate that the trust be treated as a fixed trust. Examples of such powers are:

- a power to appoint the beneficiary's interest in the income or capital to another beneficiary;
- a power to characterise receipts or expenses as being on income or capital account, or to accumulate trust income to capital (unless those otherwise entitled to the income have the same interests in the capital);
- a power to add new beneficiaries (other than by issuing new units or interests in a way that does not significantly affect the value of existing interests);
- a power to appoint any part of the trust property to a new trust with different beneficiaries or giving different interests among existing beneficiaries;
- a power to issue new interests with rights attached that significantly alter the rights or the value of the rights attached to existing interests (for example, a right to a preferential distribution of income); and
- a power to amend the trust deed to include a power capable of materially altering a beneficiary's membership interest(s).

To reduce uncertainty, it might be appropriate to provide that certain powers will not be treated as 'material' for these purposes. For example, in the MIT context, some stakeholders consider that it would be appropriate to provide a special rule to allow fixed trust treatment if:

- the trustee must treat members of the trust equally; and
- the constitution can only be amended in the way set out in section 601GC of the Corporations Act (broadly, by a special resolution of members or by the responsible entity if that entity reasonably considers that the change will not adversely affect members' rights).

Where the trust has more than one class of beneficiaries, then the test would be satisfied if:

- each class of beneficiaries either:
 - has a proportionate entitlement to the income and capital of the MIT and that proportion is the same for both income and capital; or
 - has an entitlement to a proportion of income and capital relating to a distinct group of assets (for example, Class A is entitled to income and capital from office buildings and Class B is entitled to income and capital from residential buildings) and that proportion is the same for both income and capital; and
 - the constitution can only be amended in accordance with section 601GC of the Corporations Act.

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?

2.2 USING VESTED AND NOT DEFEATED

Another option is to remove the requirement that an interest be 'indefeasible' to qualify as a 'fixed entitlement' and replace it with a requirement that the interest has not been defeated at the relevant time or over the relevant period being considered. That is, an interest would be a 'fixed entitlement' if it is vested and has not been defeated. As explained in Chapter 1, a vested interest is bound to take effect in possession at some time. It cannot be contingent. This would mean that while interests would need to be certain and identifiable, they would not need to be so certain as to be immune from future defeasance so long as they have not actually been defeated.

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?

When an interest is vested but defeasible, the quantum of the entitlements attached to that interest could continue to vary. In this context, an integrity rule could be that the 'fixed trust' test would be satisfied so long as there is no significant diminution in the value of the rights attached to units during a specified time period.

It is difficult to measure whether there has been a diminution in the value of rights. In particular, it is difficult to ensure that a change in the market value of an interest over a period of time has not been caused by other market forces.

One precedent for measuring the diminution of rights can be found in the value shifting rules.³⁵ Although the value shifting rules are quite complex, the fixed trust context would not require the many threshold conditions of the value shifting rules to be met, nor would it result in any adjustments to the cost base of interests in the trust. The rules would merely be a condition for a trust to qualify as a fixed trust during a specified time period.

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?

³⁵ Divisions 723, 725 and 727 of the ITAA 1997.

2.2.1 Continuity of ownership

A number of the provisions that use the 'fixed trust' concept use it for the purpose of identifying continuity of ownership (see the Attachment). In this context, the period over which the rights must not have been defeated will vary according to the period of ownership required.

This option would identify and measure entitlements over the relevant period or at the relevant time, having regard to the entitlement that *actually* existed, as opposed to whether they could be defeated at some future point. This approach may provide reasonable certainty about the underlying entitlement so as to achieve the intended policy outcomes, without requiring the current high standard of certainty.

For example, for the purposes of the trust loss provisions,³⁶ the test period could be from the start of the loss year to the end of the deduction year (as it currently is for determining the deductibility of a trust's tax losses). If the entitlements to all of the income and capital of the trust were vested and not defeated throughout this period, the trust would be treated as a fixed 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?

2.2.2 Tracing ownership and control

The term 'fixed trust' is commonly used for the purpose of identifying the concentration of ownership and control (see Attachment). As such, where the rights are defeasible, it may be appropriate to include safeguards to trace ownership and control.

The tax law provides tests for identifying de facto control of a trust.³⁷ These tests include circumstances where the entity, along with their associates, can control the application of the income and capital of the trust, including by way of a scheme. It also includes circumstances where the trustee is accustomed or obliged to act in accordance with the wishes of the entity or where the entity is able to remove or appoint a trustee of the trust. It may be appropriate to include similar provisions where the 'fixed trust' concept is used to identify the concentration of ownership and control.

³⁶ Schedule 2F to the ITAA 1936.

³⁷ Section 727-360 of the ITAA 1997.

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?

Options in relation to concentrated ownership and control are discussed further in relation to 'closely held trusts' at paragraph 2.4.1.

2.3 OPTIONS FOR SPECIFIC PROVISIONS

In some cases, it may be possible to remove the references to 'fixed trust'. However, this would only be appropriate in relation to specific provisions and the way in which the references to 'fixed trust' might be removed depends on their context.

2.3.1 Assets held directly and indirectly

Division 855 of the ITAA 1997 uses the term 'fixed trust' to trace ownership through interposed entities.³⁸ However, other provisions achieve a similar outcome by simply referring to the interest in the asset being held 'directly or indirectly'. As such, it may be possible to replace these references to 'fixed trust' with references to holding an asset 'directly or indirectly'.

2.3.2 Remove the distinction between fixed and non-fixed trusts

Another approach is to remove the distinction between fixed and discretionary trusts for some provisions. It may then be appropriate to include alternative rules depending on the context.

Consolidation

The consolidation provisions include a special rule that refers to the term 'fixed trust' to ensure that an entity (known as the test entity) is not prevented from being a subsidiary member of a consolidated group or multiple entry consolidated group (MEC group) merely because there is a trust that is not a fixed trust interposed between the entity and the head company of the group.³⁹

Due to the nature of the interposed trust, it may not be possible to beneficially own membership interests in the test entity. Therefore, in the absence of this special rule, it may not be possible for the test entity to be a wholly owned subsidiary of the head company.

In essence, the special rule removes the distinction between fixed and non-fixed trusts for the purposes of determining eligibility for membership of a consolidated group or MEC group. Therefore, the reference to 'fixed trust' in this special rule may not require any amendment.

³⁸ See section 855-40 of the ITAA 1997.

³⁹ Sections 703-40 and 719-35 of the ITAA 1997.

Trust loss rules

If the distinction between fixed and non-fixed trusts were removed from the trust loss rules⁴⁰ then the tests that currently apply to non-fixed trusts might apply to both fixed trusts and non-fixed trusts. As such, a fixed trust may need to satisfy the control test and income injection test and in some cases the pattern of distribution test and 50 per cent stake tests before utilising losses. Alternatively, other tests may be applied.

Question 11:

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

2.4 OTHER ISSUES

2.4.1 Closely held trusts

A 'closely held trust' is defined as a trust where up to 20 people hold rights to 75 per cent or more of the income and capital of the trust.⁴¹ At least one provision that uses the term 'fixed trust' has a similar test.⁴² However, a number of other provisions that use the term 'fixed entitlement' also use similar tests for the purposes of identifying a concentration of ownership and control.⁴³

There are subtle differences between the provisions. In some cases, the provisions will look not only at interests in income and capital, but also at voting rights.⁴⁴ In contrast, subsection 102UC(1) of the ITAA 1936 looks not only to interests in the income and capital of the trust, but also to whether it is a 'discretionary trust'.⁴⁵

Where most other provisions look to the rights of an individual and his or her relatives, section 727-360 of the ITAA 1997 looks to the rights of the entity and its 'associates', requiring that there be a right to 40 per cent rather than 75 per cent of the income and capital of the trust.

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?

40 Schedule 2F to the ITAA 1936.

41 Section 272-105 in Schedule 2F to the ITAA 1936.

42 Section 102UC of the ITAA 1936.

43 Sections 115-50, 116-35, 124-810 and 247-15 of the ITAA 1997.

44 Sections 115-50, 116-35 and 124-810 of the ITAA 1997.

45 A 'discretionary trust' is defined in section 102UC as a trust that is not a 'fixed trust' within the meaning of Schedule 2F to the ITAA 1936.

2.4.2 Connected entities

Some provisions use the term ‘fixed trust’ for the purpose of determining continuity of ownership.⁴⁶ Generally, these provisions require that at least 50 per cent of the rights to the income and capital of the trust are held by the same people at multiple points in time. The main exception is Subdivision 170-D of the ITAA 1997, which requires the member, along with their associates, to hold 50 per cent of the rights to the income and *corpus* of the trust.⁴⁷

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’?

⁴⁶ Subdivisions 165-F and 170-D of the ITAA 1997, section 719-35 of the ITAA 1997 and Schedule 2F to the ITAA 1936.

⁴⁷ Subparagraph 170-265(1)(a)(i) of the ITAA 1997.

SUMMARY OF QUESTIONS FOR COMMENT

- Question 1:** Is it appropriate for certainty and simplicity to consolidate the definitions of ‘fixed trust’ into subsection 995-1(1) of the ITAA 1997? 1
- Question 2:** Is it appropriate to remove the ‘trust instrument’ requirement from the basic definition of a ‘fixed trust’? 2
- 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? 4
- 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’)? 5
- 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? 7
- 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? 9
- 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? 9
- 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? 9
- 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? 10
- 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? 11
- Question 11:** Which provisions lend themselves to removing the distinction between fixed trusts and non-fixed trusts? What safeguards would be required? 12
- 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? 12
- 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’? 13

ATTACHMENT: PROVISIONS THAT USE THE TERM ‘FIXED TRUST’

Provision	Context	Special Features	General description
<i>Concentration of ownership and control</i>			
Section 727-360 ITAA 1997	Value shifting	An entity and its associates have rights to at least 40 per cent of the income or capital of the trust.	The value shifting rules prevent artificial losses being created by the transfer of value from asset to asset. A shift of value from or to an asset distorts the relationship between the asset’s market value and its values for tax purposes. Without appropriate integrity rules, an arrangement could enable a taxpayer to bring forward losses and postpone gains out of assets which are due to be realised in the short term and into assets which are not due to be realised until sometime later. Division 727 of the ITAA 1997 can only apply if the losing entity and gaining entity either have the same ultimate controller or common ownership. Different tests apply for determining control of a fixed trust and for a non-fixed trust. Where a trust is not a ‘fixed trust’, an entity can be considered a controller simply because the entity can benefit under the trust. Thus, any entity that is an object of a discretionary trust can be taken to control the trust for the purposes of the value shifting rules.
Section 727-400 ITAA 1997	Value shifting	One or more entities have an 80 per cent ultimate stake.	Section 727-400 of the ITAA 1997 provides that two entities (at least one of which is a fixed trust) will have common ownership if two or more ultimate owners have at least 80 per cent ultimate stake in one of the trusts. An ‘ultimate stake’ in a fixed trust is defined in section 727-410 of the ITAA 1997.

Provision	Context	Special features	General description
<i>Concentration of ownership and control continued</i>			
Section 102UC ITAA 1936	Definition of 'closely held trust'	Up to 20 individuals with rights to 75 per cent or more of the income or capital (or a discretionary trust).	The 'closely held trust' rules in Division 6D of Part III of the ITAA 1936 are designed to prevent chains of trusts from being used to avoid or indefinitely defer tax by requiring the trustee to provide the Commissioner with certain information about their beneficiaries. A trust will be closely held if up to 20 people have rights to 75 per cent or more of the income or capital of the trust, or if the trust is a discretionary trust. This will not apply if a trust is an 'excluded trust'.

Provision	Context	Special features	General description
<i>Continuity of ownership</i>			
Subdivision 165-F ITAA 1997	Company tax losses	50 per cent of income and capital plus fixed entitlement to all income and capital.	A company can deduct prior year losses only if it satisfies the continuity of ownership test (section 165-12 of the ITAA 1997) or the same business test (section 165-13 of the ITAA 1997). These tests also apply to determine whether a company can apply prior year capital losses (Subdivision 165-CA of the ITAA 1997) or deduct bad debts (Subdivision 165-C of the ITAA 1997). These rules are designed to remove an incentive for tax driven activities involving entities with prior year losses or bad debts. In particular, the continuity of ownership test prevents 'loss trafficking' (that is, purchasing defunct companies with prior year losses in order to obtain a tax advantage). The continuity of ownership test looks through interposed entities to ascertain the individuals who are 'the ultimate owners', that is, those who have the voting rights or rights to dividends or capital distributions. If a company is not able to pass the continuity of ownership test because interests in the trust are held by non-fixed trusts, the company may still be able to deduct its losses or bad debts by satisfying the alternative conditions in Subdivision 165-F of the ITAA 1997.

Provision	Context	Special features	General description
<i>Continuity of ownership continued</i>			
Subdivision 170-D ITAA 1997	Definition of 'connected entity'	Companies and their associates have a right to receive more than 50 per cent of the income or corpus of the trust.	Subdivision 170-D of the ITAA 1997 was introduced together with other loss integrity measures to prevent loss duplication, and to prevent the claim of an immediate deduction or loss, in respect of asset transfers amongst groups with common ownership. The Subdivision can apply where a company (called the originating company) transfers a CGT asset to, or creates a CGT asset in, an entity that is in the same majority owned 'linked group' of companies or one of their connected entities. The relevant deduction or loss associated with the transfer or creation is deferred and can be recognised by the originating company (only) at a time when the asset ceases to be held by any company in the linked group of which the originating company is a member or a connected entity. For the purposes of Subdivision 170-D of the ITAA 1997 a 'fixed trust' will be a connected entity at a particular time if members of a linked group of which the originating company is a member, and their associates, have between them the right to receive more than 50 per cent of any income or corpus of the trust. A 'non-fixed trust' will be a connected entity if any company within the linked group (or any associate of such a company) benefits or is 'capable of benefiting under the trust'.

Provision	Context	Special features	General description
<i>Continuity of ownership continued</i>			
Schedule 2F to ITAA 1936	Trust loss measures	50 per cent of income and capital plus fixed entitlement to all income and capital.	The trust loss provisions in Schedule 2F to the ITAA 1936 are designed to prevent the transfer of the tax benefit from deductions for tax losses, bad debts and debt/equity swap losses made by trustees. As explained in the second reading speech, Schedule 2F to the ITAA 1936 is intended to prevent a person who did not bear the economic impact of the loss from obtaining a benefit when the trust came to deduct the loss. The trust provisions differ from the company loss rules reflecting the distinctive nature of trusts. The provisions broadly recognise three types of trusts: 'fixed trusts', 'non-fixed trusts' and 'excepted trusts' and the tests regulating the recoupment of losses vary depending on the type of trust. Broadly, the rules may prevent 'fixed trusts' from deducting prior year losses unless they satisfy a 50 per cent stake test at all times during the test period. A trust that is not a 'fixed trust' may also deduct prior year losses if they satisfy the 50 per cent stake test (if applicable), and show that control of the trust and a majority of their pattern of distributions of the income or capital did not change during the test period. The trust loss provisions do not apply to excepted trusts.

Provision	Context	Special features	General description
<i>Tracing ownership</i>			
Section 104-72 ITAA 1997	Cost base adjustment for non-assessable payment for a trust interest	CGT event E4 is taken not to apply to discretionary trusts.	CGT event E4 happens if the trustee of a trust makes a payment to a beneficiary in respect of their unit or interests in the trust and some or all of the payment is not assessable. If CGT event E4 happens, the beneficiary reduces the cost base of their interest in the trust. The beneficiary makes a capital gain if the total non-assessable part of the payment is more than the cost base of the beneficiary's interest in the trust. Where non-assessable payments arising from the small business discount pass through a chain of trusts before being paid to the beneficiary at the end, there is a potential for double taxation from CGT event E4 applying to each trustee in the chain. Section 104-72 of the ITAA 1997 was inserted to prevent this problem. Section 104-72 of the ITAA 1997 reduces any capital gain (but not below 0) if the taxpayer is the trustee of another trust that is a 'fixed trust' and is not a complying superannuation entity. In this context, the 'fixed trust' concept is used to trace ownership through a series of entities. If a taxpayer is not a trustee of a 'fixed trust', then it is not able to reduce the capital gain under section 104-72 of the ITAA 1997.

Provision	Context	Special features	General description
<i>Tracing ownership continued</i>			
Sections 703-40, 713-50 and 719-35 ITAA 1997	Consolidation	Membership of a consolidated group or a MEC group.	The consolidation regime aims to reduce tax compliance costs and improve the integrity of the income tax system by allowing a group of corporate entities the choice to lodge a single income tax return if, broadly, they are all wholly owned by an Australian resident company. The head company lodges the income tax return for the group, while the subsidiaries lose their individual income tax identities. The consolidation membership rules include a special rule that refers to the term 'fixed trust'. When a non-fixed trust is interposed between the head company and a subsidiary member, the rule operates for the purposes of determining eligibility for membership of a consolidated group or MEC group by removing the distinction between fixed and non-fixed trusts (sections 703-40 and 719-35 of the ITAA 1997). As a consequence of the rule, the subsidiary member may still be identified as a wholly owned member of the consolidated group or MEC group. In this context, the term 'fixed trust' is used for the purposes of tracing ownership through interposed entities. When an entity joins a consolidated group, the tax cost setting rules apply to reset the tax costs of the joining entity's assets. If the joining entity is a trust, the operation of the tax cost setting rules is modified (Subdivision 713-A of the ITAA 1997). Section 713-50 of the ITAA 1997 specifies factors that can be taken into account to determine the destination of distributions by a non-fixed trust for the purpose of applying the tax cost setting rules.

Provision	Context	Special features	General description
<i>Tracing ownership continued</i>			
Section 855-40 ITAA 1997	Capital gains or losses by foreign residents.		Division 855 of the ITAA 1997 provides that a foreign resident can disregard a capital gain or loss unless the relevant CGT asset is taxable Australian property (including indirect holdings of Australian real property). The provisions were intended to further enhance Australia's status as an attractive place for business and investment, and to align the CGT laws more closely with OECD practice. Section 855-40 of the ITAA 1997 allows a foreign resident to disregard a capital gain that is made in respect of an interest in a 'fixed trust' (or chain of 'fixed trusts') if it relates to an asset that is not taxable Australian property of the trust, or other conditions are met. The concept of a 'fixed trust' is essential to enable the tracing of property to its ultimate owner. The concept is also important to ensure rights, obligations or entitlements attached to the property cannot be varied between foreign and resident beneficiaries which could result in an exemption being improperly accessed. This is done by measuring the percentage interest of one entity (the foreign resident or an interposed trust) in a trust and this can only be objectively done for 'fixed trusts'. In this context, the 'fixed trust' concept is used for the purpose of tracing ownership through one or more entities. A foreign resident is not able to disregard a capital gain that arises from an asset that is not taxable Australian property if they hold the asset through a trust that is not a 'fixed trust' (or a chain of trusts where even one trust is not a 'fixed trust') even though they would have been able to disregard the gain if they held the asset directly.