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PRIVATE AND CONFIDENTIAL

Dear Sir/Madam

SUBMISSION - A MORE WORKABLE APPROACH FOR FIXED TRUSTS

Grant Thornton Australia Limited (Grant Thornton) appreciates the opportunity to provide comments to Treasury on the Discussion Paper "A more workable approach for fixed trusts" dated 30 July 2012.

Grant Thornton's response reflects our position as leading advisors to family groups and privately held companies and businesses as well as to smaller firms assisting that sector.

Our response comprises our submission regarding Grant Thornton's alternative model for fixed trust taxation together with responses to the specific discussion paper questions detailed in the accompanying appendix.

FIXED TRUST REFORM

We strongly support the Government's agenda to increase certainty in the taxation of trust income and reduce compliance costs, not only for taxpayers but also the Australian Taxation Office (ATO). For the same reasons, we also support the Government's objective to address the uncertainty as the current system for fixed trusts has, for a long time, created a regime where, arguably, very few trusts qualify due to the stringent requirements and the narrowly interpreted definition.

We believe that any changes to the fixed trust regime must therefore provide increased certainty and simplicity to allow fixed trusts to function effectively whilst maintaining the integrity of the law.

We believe that to reduce complexity and uncertainty around this regime, the proposed measures must introduce a fixed trust model which only requires the Commissioner's discretion in a minority of cases at most. To accomplish this, we believe the Fixed Trust regime should operate on an elect in basis similar to the Family Trust regime. A straightforward set of rules should be introduced where a taxpayer can self-assess if they meet the requirements of the fixed trust regime. If the taxpayer does not meet any of the predetermined rules, or fails to continue to meet the rules during any income year, they cannot operate as a fixed trust.

PROPOSED FIXED TRUST MODEL

Eligibility

A trust could elect to be a fixed trust where beneficiaries have an interest in the trust that would result in a CGT Event E4 occurring in the instance that non-assessable amounts were paid to those beneficiaries.

The relevant beneficiaries could be described as the "fixed" beneficiaries.

Further, we believe a fixed trust treatment should be automatically provided (or perhaps via election) to those trusts that are Managed Investment Trusts, widely-held, listed, controlled by institutions and/or managed pursuant to the *Corporations Act*.

Application

The trustee would need to make an election that the eligible trust is a fixed trust. Thereafter the trust would be part of the fixed trust regime with the consequences including that:

- trusts must only distribute income and capital within the group of "fixed" beneficiaries;
- reduced compliance for carry forward of tax losses;
- pass through of franking credits.

Distributions of income or capital would be taxed in accordance with current rules when distributed to the "fixed" beneficiaries. Penalty taxes would apply for distributions outside the "fixed" beneficiaries group.

Whilst the election to become a fixed trust could conceivably be irrevocable, the ATO should be notified annually in the tax return if fixed beneficiaries have changed, due to, for example, one fixed beneficiary disposing of their trust interest or a beneficiary has deceased.

Benefits of Electing to be a Fixed Trust

The Treasury's Discussion Paper outlined those provisions of the Income Tax Assessment Act 1936 or 1997 that currently use the term 'Fixed Trust'. We believe our proposed fixed trust model would be aligned with the objectives of these existing provisions. For example:

1. The value shifting provisions seek to identify common owners and/or controllers. Under our proposed fixed trust model the common owners and/or controllers would be the 'fixed beneficiaries' identified in the fixed trust election.

2. The company loss provisions require a company to satisfy a continuity of ownership test. A trust that has elected to be a fixed trust under our proposed model (and/or the underlying 'fixed beneficiaries') could therefore be treated as an 'ultimate owner', having rights to dividends or capital distributions.

3. The trust loss measures provide for different loss recoupment rules for fixed trusts and non-fixed trusts. Adopting our proposed fixed trust model would alleviate a common

problem in utilising losses incurred by unit trusts with, for example, two unrelated family groups as unit holders. Currently, such a unit trust may not be considered a fixed trust. The only solution to this, making a family trust election, is impractical as it would be to the detriment of one or more families.

4. For tax consolidation purposes, head companies and fixed trusts could make an election to consolidate with more certainty if our proposed fixed trust model were adopted. The election would identify those fixed beneficiaries.

5. The current application of section 855-10 – capital gains or losses by foreign residents – means that a foreign ***individual*** resident could disregard a capital gain or loss unless the relevant CGT asset is taxable Australian property. That same treatment applies under section 855-40 if the relevant CGT asset is held via a fixed trust. However, the strict interpretation of this term means that this section is relatively obsolete. By adopting our proposed fixed trust election model and identifying the fixed beneficiary will allow section 855-40 to operate as intended.

The remainder of our submission, as outlined in the accompanying appendix, addresses our answers to the questions raised in the Discussion Paper.

Should you have any queries in relation to these matters, please contact me on 02 8297 2509 or peter.berg@au.gt.com

Yours sincerely
GRANT THORNTON AUSTRALIA LIMITED

Peter Berg
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Enc

Appendix

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

Yes, we believe it would be appropriate to consolidate the definitions of 'fixed trust' into subsection 995-1(1). However we do not favour the result of any such consolidation having retrospective effect in a manner that is unfavourable to taxpayers. We expect that appropriate transitional provisions should provide a suitable time period to allow taxpayers sufficient time to understand the effect of the changes.

Any transitional provisions introduced should also provide taxpayers with the certainty that any amendments made to the trust deed to achieve a 'fixed trust' status do not result in a trust resettlement, or if it does, that rollover relief is granted.

Further, any new definition of 'Fixed Trust' should not impact on the current understanding or interpretation of the meaning of 'Unit Trust'.

Q.2 - Is it appropriate to remove the 'trust instrument' requirement from the basic definition of a 'fixed trust"?

In focusing on whether or not an interest is held which may give rise to a CGT Event E4, our proposed model would potentially make the 'trust instrument' requirement redundant, but it would be useful for evidentiary purposes.

The absence of a 'trust instrument' requirement, while potentially providing greater flexibility, may lead to a lack of certainty for all parties as to when a fixed trust has been brought into existence. This may lead to increased or protracted correspondence with the ATO in certain circumstances resulting in a consequential impact on both taxpayers and ATO compliance costs.

The aim of the 'fixed trust' concept is to provide access to certain measures not otherwise available to all trusts. Therefore the inclusion of a 'trust instrument' should be a requirement if a taxpayer wants to self-assess their eligibility. Alternatively, if a taxpayer wants the Commissioner to exercise his discretion then a 'trust instrument' should not be a mandatory requirement.

Q.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?

Yes, we believe it is appropriate to provide that an entitlement is not to be taken as being defeasible simply because of the existence of certain powers. There are numerous examples, some of which are provided below, of when it is highly unlikely or extremely remote that powers will be exercised that would otherwise result in an entitlement being defeased.

However, to introduce a definitive list of powers that should not be taken as defeating an entitlement risks introducing further complexity. We suggest that provision should be made to recognise that certain powers would be potentially defeasible but the effect of any non-defeasance should only arise in the event of the provisions being invoked.

Here are some examples of situations where arguably an interest would be considered defeasible under the current definition of 'fixed trust' even if the power is never exercised:

- The trustee has the power to consolidate, divide or re-classify units as it thinks fit;
- The trustee may issue different classes of units or divide issued units into different classes;
- The trustee may issue units at a discount to net asset value;
- The trustee may issue options over units;
- The trustee has the power to determine the trust's income;
- The trustee may establish and distribute reserves as it thinks fit;
- The trust has a life of 80 years;
- The trustee may amend the deed in any form it thinks fit;
- The Trustee may determine whether to exercise, and the manner, mode and time of exercise of its powers, in its absolute discretion; and
- Provisions denying a beneficiary an interest in the trust assets, and specifying that beneficiaries have an interest only in the cash surplus on a winding up.

Q.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)?

Yes, we believe the definition of indefeasible as set out in the *Colonial* decision will be too restrictive in certain cases. For example, the situations summarised above in Q.3 are powers that the trustee has in a trust deed that could cause a unit holders interest to be defeated. The Colonial case also considered that trustee powers requiring unit holder consent could cause those interests to be defeated.

Another common situation where an interest in a fixed trust could be defeated is in the context of financing arrangements where the terms of a borrowing by a lender to the fixed trust could, in the event of a default, result in the lender effectively defeating those interests.

In this context you should also consider the potential impact of fixed trust financing arrangements where classes of finance unit holders have the ability to defeat the entitlements of other unit holders in certain circumstances. Unit holders exercising such rights should not result in the rights of other unit holders being considered defeasible.

Q.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?

Our concern is that a 'no material discretionary elements' approach in relation to a clearly defined rights test is judgemental or subjective. This in turn may lead to differing views as to what is material and what is not, and may result in more uncertainty, as well as increased costs for the taxpayer and the ATO.

We believe that this proposal would not achieve the objective of introducing a fixed trust test that is simple and certain to administer.

Q.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) be applied?

As indicated in our response to Q.5 we believe it is unhelpful to attempt to prescribe certain powers as 'material' or not. Further, we believe it would be extremely difficult to provide a clear set of rules to apply in all circumstances as to what is 'material'. Such an approach is unlikely to aid clarity or create more certainty and simplification for taxpayers.

Q.7 - Is it appropriate to allow fixed trusts treatment where rights are vested but are not indefeasible? If so, in which cases is it inappropriate?

As a general principle we believe it is appropriate to allow fixed trusts treatment where rights are vested but are not indefeasible including circumstances where the potential defeasance is a theoretical risk only. Other circumstances in which it may be appropriate to provide for fixed trust treatment include where unit holders declare that this is their collective wish.

Further, we believe a fixed trust treatment should be automatically provided (or perhaps via election) to those trusts that are Managed Investment Trusts, widely-held, listed, controlled by institutions and/or managed pursuant to the *Corporations Act*.

Q.8 - If a 'vested but not defeated' test is adopted, what rules might be adopted to identify whether the rights have effectively been defeated?

Whatever the shape of the reforms to the taxation of fixed trusts, we would prefer a simplified, straight forward approach. We believe a fixed trust should be treated as a fixed trust and there should not be an attempt to go behind this treatment in search of testing if rights have somehow effectively been defeated.

We believe there should be sufficient anti avoidance provisions in the code to prevent inappropriate use or manipulation of fixed trusts in this area.

Q.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?

Yes, we believe that for those provisions using the fixed trust definition (other than the continuity of ownership) it is sufficient that the rights have not been defeated at the time the test is applied.

In relation to those provisions dealing with continuity of ownership we do not see any benefit in removing the 'fixed trust' concept from these types of tests. The current core issue with the 'fixed trust' concept is not in its use but in its definition. If the definition is fixed then the application of that concept throughout the Income Tax Assessment Act should be more easily applied.

Q.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 ITAA 1997? Is there a more appropriate way of removing the 'fixed trust' concept from tests that are used for tracing ownership and control?

In our experience the application of Section 727-360 ITAA, control for value shifting purposes is complex and in practice often leads to a view being reached that no definitive conclusion is possible. This then leaves Trustees with a considerable administrative burden and in an uncomfortable position and/or having to incur often significant professional fees. As a result our view is that a de facto test would add further complexity to an already complex area and would therefore not be appropriate.

As an alternative approach our proposed elective regime for fixed trusts would provide a very practical solution to tracing of ownership and control. In practice it would work in a very similar way to the Family Trust Election.

Q.11 - Which provisions lend themselves to removing the distinction between fixed trusts and non-fixed trusts? What safeguards would be required?

Removing the distinction between fixed and non-fixed trusts would substantially remove compliance costs.

If this occurs, safeguards would be needed to prevent the trafficking of tax losses and franking credits generated inside trusts. This could be dealt with by requiring a continuity of underlying control, rather than the current prescriptive approach.

Q.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?

We agree that the term 'closely held trust' be defined for the purposes of the ITAA 1997 and other provisions rely on that definition rather than replicating it.

However, we believe that the focus should remain solely on defining a 'fixed trust' given that it has been a significant long outstanding issue. Any tinkering required to 'closely held trust' should perhaps be considered as part of the Government's overall trust reform agenda.

Q.13 - Is it appropriate to bring the definition of connected entity into line with other provisions by referring to the 'capital of the trust' instead of the 'corpus of the trust'.

Corpus is a legalistic concept and we agree that it would be appropriate to align the other provisions by reference to 'capital of the trust' provided that there is no change to the underlying tax treatments.