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Dear Sir

Trust cloning amendments

The Taxation Institute of Australia (**Taxation Institute**) welcomes the opportunity to provide comments on the exposure draft of the *Tax Laws Amendment (2009 Measures No. 6) Bill* 2009 and the related explanatory memorandum (**Exposure Draft Material**). The Exposure Draft Material concerns the abolition of the trust cloning exception and providing rollover relief for fixed trusts.

The Taxation Institute has some significant concerns in relation to the Exposure Draft Material. These concerns are outlined below.

Fixed trusts

The heading "transfer of assets between eligible fixed trusts" gives the impression that the defined term "fixed trust" (as defined in s.995-1(1) of the *Income Tax Assessment Act 1997*) is invoked. The Taxation Institute does not consider that the definition of “fixed trust” has any application in relation to the proposed subdivision 126-G. Accordingly, the Taxation Institute considers that this should be made clear. This could be achieved by removing the reference to “fixed trust” in the heading or amending the definition of "fixed trust" in s.995-1(1) to add the following words: "This definition has no application in subdivision 126-G." Similar amendments would be required in relation to proposed s.112-54A and s.112-150.

If subdivision 126-G is restricted to "fixed trusts" as defined by s.995-1(1), this would make the rollover ineffective as few trusts (if any) would satisfy the conditions. In this regard, it is noted that most trusts in commerce, which are colloquially known as “fixed trusts”, have elements of discretion which make the application of the definition of "fixed trust" problematic. If none of these trusts are able to use the rollover, the rollover intended to be provided by subdivision 126-G will be ineffective.

Exclusion of a discretionary trust

Further to the comments above in relation to references to “fixed trusts”, Note 1 to proposed s.126-225(1) also has the potential to make the intended rollover ineffective. The Taxation Institute suggests that Note 1 should be deleted.

This view arises as a result of the High Court's long-held views about standard unit trusts. The standard clauses in unit trust deeds, such as in the unit trust in *MSP Nominees Pty Ltd v Commissioner of Stamps (South Australia)* (1999) 198 CLR 494; [1999] HCA 51, are set out at the beginning of the judgment in paragraphs [2]-[6]. At paragraph [7], the unanimous High Court of Australia said:

> *The significant provisions made by the Trust Deed for the exercise of powers and discretions by the Trustee with respect to distributions to Unit Holders support the description of the trusts established by the Trust Deed as discretionary trusts. Clause 4 denied any entitlement to Unit Holders to require a distribution, other than pursuant to cl 11. Of the methods for distributions specified in the Trust Deed, only the first … conferred upon Unit Holders rights not dependent upon or preconditioned by a requirement of consent by the Trustee or the exercise of a power vested in the Trustee.*

Given that the High Court of Australia has described a unit trust, in standard form, as a *discretionary* trust, Note 1 to proposed s.126-225(1) would make the proposed rollover ineffective.

Wording in ss.126-225(1)(c)

The Taxation Institute considers that ss.126-225(1)(c) should use the word "or" rather than the word "and" between the words "units" and "interests". Otherwise, it implies that the trust must have units and interests, which is contrary to s.104-70 (CGT event E4) and inconsistent with paragraph 1.26 of the proposed Explanatory Memorandum (**EM**).

Intent of ss.126-230(1)(b)

The Taxation Institute considers that the intent of proposed ss.126-230(1)(b) is unclear. Further, the Taxation Institute considers that the circumstances in which a beneficiary's membership interest in a trust would not satisfy the conditions in paragraph (b) should be clarified.

Constituent documents - ss.126-230(1)(c)

Proposed ss.126-230(1)(c) requires the "nature and extent of each beneficiary's membership interests … be capable of being worked out solely from the constituent document of the trust".

This raises two points, one about documentation, and the second about the intent of the provision. For the reasons given below, the Taxation Institute considers that paragraph (c) should be deleted.

Documentation issue

It is common for the particular rights attached to a class of units to be set out in a resolution or in a unit certificate, rather than in the constituent document of the trust. Further, it is common for parties to enter into unit holders' agreements intended to govern the relationship between unit holders, often in ways which impact upon the exercise of rights and powers.

The Taxation Institute considers that these common arrangements should not impact on the ability of a trust to access the rollover provided under subdivision 126-G.

Further, some rights and powers exist by statute, and in some cases cannot be excluded by the trust deed. One example is the non-excludable power of appropriation which ends a beneficiary's interest and is conferred by s.33 *Trusts Act* (Qld). That power is not set out in the constituent document of a trust, but in a statute.

Intent

From the EM (refer paragraphs 1.29 and 1.30), it appears that paragraph (c) might be intended to deal with the exercise of discretion by a trustee in relation to the appointment of income and capital.

The Taxation Institute submits that it is common place for there to be an ability on the part of the trustee to determine that amounts be treated as capital or income, to determine distributable income in a

certain way (for example, by reference to the concept of *net income* of the trust estate), and to permit the trustee to resort to capital in maintaining the level of payments to income beneficiaries.

This can be particularly useful where an income beneficiary would be taxed in respect of a net capital gain, which strictly is an affair of capital. It appears that these common powers are the underlying reason for ss.126-230(1)(c).

Therefore, the Taxation Institute cannot support paragraph (c) in its present form. In practice, there would be few trusts (if any) that would be able to satisfy this condition and qualify for the rollover. Accordingly, this would make the intended rollover ineffective.

Same market value - ss.126-230(1)(e)

The test in ss.126-230(1)(e) which requires the market value of each beneficiary's membership interests in both trusts to be the "same" is unworkable. The High Court of Australia defined "same" as "identical" in *Avondale Motors (Parts) Pty Ltd v Federal Commissioner of Taxation* (1971) 124 CLR 97, p.105, [1971] HCA 17, para [13].

A trustee would only take action where there is benefit to the beneficiaries. For example, the separation of assets may have a positive effect on the value of units held by beneficiaries. Indeed, it may be a breach of trust for a trustee to act otherwise. Conversely, a trustee acting with the best of intentions might nevertheless find with hindsight that unanticipated loss of synergies or loss of economies of scale has led to a decrease in the value of membership interests.

A test requiring that values be the "same" would be interpreted strictly by the Courts and may make the intended rollover unworkable and ineffective as many trusts would not be able to qualify for the rollover. Accordingly, the Taxation Institute considers that the word "same" should be replaced by "substantially the same". Alternatively, if the intent of this section is actually to ensure that the receiving trust is a clean-skin trust, paragraph (e) should be amended so that this is clear. A further alternative would be to delete paragraph (c) on the basis that it would be a breach of trust for the trustee to act otherwise than in an attempt to maximise the interests of the body of beneficiaries.

Powers materially to alter - ss.126-230(2)

Proposed ss.126-230(2) contains the word "materially". This introduces a partially subjective test, which is likely to result in numerous requests for rulings and advice from the Commissioner.

The Taxation Institute is also concerned by the examples given in the EM of the powers that would be considered capable of materially altering a beneficiary's interest (refer paragraph 1.32). The Taxation institute is particularly concerned with the last two bullet points in paragraph 1.32 of the EM.

It is not known whether any standard unit trust presently in existence could satisfy this condition. A standard power to amend to accommodate regulatory changes would presumably breach ss.126-230(2)(a). Such a power is necessarily kept broad in trust deeds.

A further difficulty is that no relief appears to be offered to enable trusts, whose deeds contain provisions which would fall foul of ss.126-230(2)(a) to amend the trust deed to comply with the requirements.

The Taxation Institute is also concerned that paragraph (a) does not expressly permit a power to redeem a beneficiary's interest, which must be a power materially to affect that interest. Paragraph (a) does not permit of a power to issue further units which might, in particular circumstances, result in a change in the balance between unit holders (for example, for voting purposes, where a unit holder might lose voting control because of an issue of units to a third party at market value).

The Taxation Institute considers that paragraph (a) should be drafted such that if paragraph (b) is satisfied (ie the issue or redemption is not at a discount of more than 10%) then paragraph (a) should not be breached.

Mirror Choices - ss.126-235(3)

The Taxation Institute has concerns regarding ss. 126-235(3). The Taxation Institute is concerned that there will be a degree of accidental non-compliance and also an amount of debate concerning what amounts to a choice which is relevant for the purposes of the section.

There is no discretionary means of overcoming accidental non-compliance. For example, an existing trust which chose to return its income on the basis of trading stock at market value has made a choice for taxation purposes. That choice may never arise for a new trust which does not (and does not intend to) have trading stock. Further, some choices are only made at the point of filing an income tax return so the new trust may not yet have had the opportunity to make the relevant choice.

The Taxation Institute considers that the legislation should be amended to specifically identify any choices which are of concern to the Treasury and specify that these choices must be mirror choices.

Offence – notice – s.126-255

Section 126-255 makes it a strict liability offence for a trustee to fail to give a notice to a beneficiary.

With a public offer trust, or one that is otherwise widely held, it will literally be impossible to give notice to all beneficiaries. A certain proportion of notices (as with any mailing to beneficiaries) will always fail to reach the beneficiary owing to, for example, a change of address or the death of the intended recipient.

It is not clear why it was thought necessary to include a strict liability offence which will effectively make the intended rollover ineffective as no trustee will be willing to seek rollover on the basis that they may be subject to a penalty. The Taxation Institute considers that this section should be redrafted so that there is no offence if the trustee has attempted to notify the beneficiary based on the beneficiary's address or email address last known to the trustee.

A more practical solution may be to permit the trustee simply to publish details on a website in the way permitted in other circumstances (eg s.12-395(2)(b) of Schedule 1 to the *Taxation Administration Act* 2001).

Part 3 – other amendments

The proposed amendment to ss.104-10(2) in Part 3 to the Schedule adds two sentences of notes for the sake of deleting one sentence in the substantive provision.

Although it is acknowledged that the deleted sentence was only inserted for the sake of clarity, the Taxation Institute considers that there is no reason for changing the substantive provisions of the Act to include the comment in the notes to s.104-10(2).

Other comments

The Taxation Institute is concerned by the proposed retrospectivity to 31 October 2008 of these measures. By the time of their enactment, more than 12 months will have passed since the press release announcing the proposed changes contained in Part 1 of the Schedule to the Exposure Draft.

The Exposure Draft Material illustrates what appears to be an ongoing trend of retrospectivity in taxation legislation. The Taxation Institute has concerns regarding this trend.

The Taxation Institute has not seen any proposed drafting for a depreciable asset rollover. The Taxation Institute would welcome the opportunity to comment on these provisions.

The reforms – too narrow

In conclusion, the Taxation Institute considers that the rollover provisions (as currently drafted) are ineffective and not workable as very few (if any) trusts will be able to satisfy the requirements to obtain

rollover relief. The Taxation Institute hopes that the examples provided above will initiate a revised approach to drafting the proposed measures.

More broadly, the Taxation Institute considers that the dichotomy between fixed trusts (of which there are relatively few in commerce) and discretionary trusts should be abandoned. The government should consider extending the rollover to discretionary trusts where, as a condition of rollover relief, the trusts are subject to a family trust election or interposed entity election in respect of the same test individual.

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If you would like to meet with representatives from the Taxation Institute or require any further information or assistance in respect of our submission, please contact Joan Roberts on 03 9611 0178 or the Taxation Institute's Tax Counsel, Angie Ananda, on 02 8223 0011.

Yours faithfully

Joan Roberts
President