

## JOINT SUBMISSION BY

**Chartered Accountants Australia and New Zealand, The Tax Institute,  
Tax and Super Australia, CPA Australia and  
Institute of Public Accountants**

### **Draft Practical Compliance Guideline PCG 2016/D16**

#### **Fixed Trusts**

**Date: 9 December 2016**

---

The Professional Bodies welcome the opportunity to comment on Draft Practical Compliance Guideline PCG 2016/D16 (PCG).

#### **GENERAL COMMENTS**

We welcome the ATO's decision to try to bring some clarity to the meaning of 'fixed trust' by formally articulating the range of matters the ATO will consider in deciding whether to exercise the discretion to treat an entitlement as a fixed entitlement. Given that legislative change on this matter is unlikely, this is a useful way of enhancing the level of certainty that taxpayers outside the Attribution Managed Investment Trust (**AMIT**) regime and family trust regime can enjoy on this important issue.

However, we consider that the draft PCG would benefit from clarifying certain terms as well as incorporating examples that are more practical and representative of the current market. We believe that this is important to ensure that taxpayers and their advisers are able to rely on the PCG with a higher degree of certainty.

Below are our specific comments and recommendations to enhance the PCG's utility to taxpayers and their advisers.

#### **SPECIFIC COMMENTS**

##### **1. Scope**

First, the PCG says it is only purporting to interpret the meaning of 'fixed trust' for the purpose of the trust loss provisions [para 1] even though, as Attachment A demonstrates, the same term is used in many other provisions. Why the PCG is quarantined to this topic is not clear.

We can see no structural reason why the PCG should not extend to other regimes such as the franking credit rules (including under former Division 1A of the ITAA 1936), the non-arm's length income rule ("NALI") in Division 295 of the ITAA 1997, the CGT discount or the value-shifting rules. Those regimes typically adopt the term 'fixed entitlement' and s. 995-1 of the ITAA 1997 then directs the reader to the definition in Division 272 of Schedule F to the ITAA 1936, which picks it up in s. 272-5 including subsection (3). There seems to be no legislative impediment to having the examples in the PCG extend to other regimes which also adopt the term 'fixed entitlement'.

The logic and reasoning of the examples could be directly transferrable to the analysis of trusts for the purposes of those other regimes.

### **Franking credit discretion**

As stated above, we recommend that the final PCG should consider the franking credit discretion provided to the Commissioner under the former subsection 160APHL(14) of the ITAA 1936. The wording of this discretion is very similar to the Commissioner's discretion under subsection 272-5(3) and it would therefore be efficient if the PCG dealt with subsection 160APHL(14).

We understand that it may be difficult to exercise the discretion where the relevant class has no right to capital, so does not carry an interest in the corpus (though it would be rare for a unit not to carry at least a return of the issue price on a winding up).

However, we see no reason why the Commissioner should not exercise his discretion under former subsection 160APHL(14) in circumstances where all beneficiaries have a consistent proportionate entitlement to dividends and capital gains from the shares in a trust and those entitlements are effectively not discretionary.

### **Non-arm's length income rule (NALI)**

We also disagree that the Commissioner's view, as expressed in TR 2006/7, is required to be applied under the new Division 295 of the ITAA 1997 in relation to the NALI provision. We believe that the move of the provisions to the ITAA 1997 allows the defined term "fixed entitlement" to be used (which provides a link to the discretion in Schedule 2F). (We have elaborated on this point in the Appendix to this submission).

If the Commissioner does not accept our submission that the PCG should be amended to have corresponding guidance on the other provisions to which the s. 275-5 fixed entitlement definition is relevant (which we consider is highly desirable), we believe that the Commissioner should otherwise publicly confirm that the PCG applies to that provision. However, if in the particular case the legislative context or other factors require, guidance adapted from the PCG but modified to address that particular provision should be published by the Commissioner.

## **2. Status of this PCG**

This document has been issued in the form of a Guideline rather than a Ruling. As PCG 2016/1 makes amply clear –

24. As practical compliance guidelines are not public rulings, they will not have the legally binding effect of a ruling

.However, PCG 2016/1 says taxpayers should take comfort from the fact that –

27. The ATO has good reason to stand by approaches outlined in practical compliance guidelines.

Be that as it may, the decision not to issue a Ruling is presumably a deliberate choice, and it sends possibly the opposite message.

We appreciate that there may be concerns that, as a matter of administrative law, the Commissioner cannot address this matter using a Ruling because a Ruling would fetter the exercise of his discretion. If that is the reason, it should be spelt out because that view is contestable.

## **3. Improving the examples**

As to the substance of the PCG, the 21 Examples differentiate innocuous situations and unacceptable situations using four variables –

1. provisions in the trust's constitution;
2. the regulatory and market environment;
3. the prior administration of the trust; and
4. whether the trust is a 'private trust' or Managed Investment Scheme (**MIS**) (or its status is not mentioned).

While these are all possibly relevant matters, there is no explanation about how these ideas interact. The absence of a compelling explanation about why these variables matter and how much they matter and why other variables don't matter means the value of the PCG is not as

high as it could be. Clearly Example 1 covers a significant number of trusts however, most of these trusts would be AMITs anyway and so for them the PCG is unimportant. However, for other trusts practitioners are left with uncertainty regarding just how closely their facts of those trusts need to match the facts of one of the Examples. For example, the PCG does not express a view on whether a bare trust is a fixed trust, or whether a trust with just a single unitholder can be treated as a fixed trust while that situation exists.

Examples are helpful if they either:

- (i) cover most of trusts on their terms, or
- (ii) set out principles which allow their scope and impact to be extrapolated.

This PCG does neither. For example, Example 2 involves Variable 1 (units may be redeemed at a price close to net asset value), Variables 2 and 4 (the trust is unlisted but it is an MIS and managed by an AFSL holder) and Variable 3 (the trustee has never exercised the power to amend the constitution). Is it the case that all Variables have to be present? If not, which ones can be dispensed with? Are they all equally important?

For the PCG to be more helpful, an explanation as to why conclusions are reached and which facts were important and which were not and why needs to be addressed.

#### **4. Broadening the application of paragraphs 16 and 17**

We suggest that there is scope to more broadly apply paragraphs 16 and 17 in the PCG. That is, a trust could be deemed to be a fixed trust in the relevant period to the extent that:

- a) The trustee has not had a practice of exercising discretions in a way that would defeat the rights of any particular unit holder during the relevant period; and
- b) There has been no tax mischief with respect to the relevant integrity provisions relating to the relevant fixed trust provisions.

On the basis (and assumption) that the final PCG will incorporate the broadened scope as recommended in section 1 above, we suggest that 'tax mischief' would mean:

- (a) trading in franking credits that would circumvent the 45 day holding period rules;
- (b) utilising tax losses where economically there has been a change of the investors; or
- (c) the income distributed to superannuation fund circumvents the integrity of the arm's length rule.

#### **5. Automatically treating a registered managed investment Scheme (MIS) as a fixed trust**

We recommend that a registered MIS should automatically be treated as a fixed trust for the purpose of income tax law, unless there are exceptional circumstances (similar to listed trusts in Example 1).

A registered MIS is subject to a significant degree of legislative requirements imposed under the Corporations Act ("CA") 2001. These strict statutory conditions make it extremely rare that a registered MIS will be capable of defeating the rights of members without simultaneously breaching the requirements under the CA 2001. Accordingly, it would be rare that members of a registered MIS should be treated as not having fixed entitlements to the income and capital of the MIS.

Similarly to the administration of the "clearly defined rights" principle discussed in LCG 2015/4, we suggest that there is little or no practical utility in a registered MIS having to

address a myriad of criteria in order to determine its status as a fixed trust. Rather, such a process should be applied to unregistered MISs or other schemes which are not confined to the strict legislative restrictions under other Acts.

## **6. Use of net asset value equivalents for the discretion**

We recommend that the PCG include a section that discusses “value” for the purpose of the discretion and clarifies that either market value or a value approximating net asset value is acceptable. We also recommend that the PCG clarify that the Commissioner will accept as a net asset value an amount that the Commissioner believes is “a sufficient approximation of a trust’s net asset value.”

We believe that the following should be acceptable in determining the value at which units are issued or redeemed and should be expressed in the PCG:

- a) The market value of assets.
- b) The value of units determined based on the value of assets determined in accordance with appropriate valuation methodologies where there is no market for the asset.
- c) The value of units based on net Asset Value including reasonable adjustments for transaction costs.
- d) The value of units based on net Asset Value including reasonable adjustments for buy-sell spread.
- e) The value of units based on net Asset Value including adjustments for cum-distribution depending on whether the Fund has roll-up or day’s basis distributions.

Accordingly, references to “market value” in the various examples and paragraphs could therefore be replaced with a concept of an “acceptable NAV” for the purpose of the PCG - or, for simplicity, merely “NAV”.

## **7. Income re-characterisation and capitalisation**

We are concerned with Example 21 of the draft PCG and recommend that it be rewritten. The mere power of re-characterising trust receipts as either income or capital (or accumulating amounts as capital) should not invalidate the existence of there being a fixed trust. If this were the case, we believe that this may lead to a significant number of trusts falling outside the PCG.

Most, if not all of the constituent documents, from which the powers of trustees or responsible entities are sourced, provide for the ability to re-characterise amounts as being on either income or capital account. Furthermore, they would also allow an amount to be accumulated by carrying the amount to a reserve. It would be exceptionally rare for a trust to never exercise this power.

For example:

- a) Re-characterisation may occur in the simple case of the 50 per cent CGT discount component. This is particularly important where the amount is streamed to a significant redeeming unit holder under the streaming provisions (which we note is acceptable for AMITs under section 276-210(5)).
- b) Re-characterisation may occur where the definition of income is based on “taxable income”, where income that has accrued for tax purposes has yet to be received by the trust (e.g. due to the application of Division 230 on a deferred security). A re-characterisation of the amount to a capital reserve (i.e. so that distributions can be limited to cash) should not change the fact that the trust is fixed as the unit holders would still have a future entitlement to the amount (and thus it would be reflected in the NAV of the unit price). By not re-characterising, this would give rise to commercial issues (such as a demand by a unit holder to a distribution of cash that cannot be funded).
- c) Re-characterisation may occur where the definition of income is based on accounting concepts. In a property fund, a trustee may make adjustments for non-cash amounts such as revaluation amounts and depreciation. Capitalising these amounts via an income re-characterisation clause should not invalidate the trust from being considered a fixed trust.

In our view, points “iv” and “v” in Example 21 provide unrealistic instances where a trustee has never exercised the power to re-characterise income and where no amounts have ever been capitalised by the trustee in a reserve.

That said, our understanding is that most such so-called “recharacterisation” powers are quite limited in scope, as addressed in *Forrest v FCT* 2010 ATC 20-163 paragraphs 27 and 28.

Furthermore, in the rare case that amounts must be streamed, we reiterate that the AMIT rules under s 276-210 of the ITAA 1997 provide the ability to stream amounts to redeeming unit holders. We see no reason why Division 115 cannot be used in the same manner (e.g. for a wholesale unregistered scheme), without invalidating the trust as a fixed trust. In other words, if the trustee is able to stream income or capital on a redemption from the sale of assets to fund a redemption, this should not mean that the rights are not fixed (especially given that there is no change or diminution in the value of any member’s units and the classification of an amount as income or capital is purely to help ensure that members are not taxed inappropriately or double taxed).

We recommend that this requirement in its current form be removed. It can be replaced with an example in which the purpose of the exercise of the relevant powers is not to stream amounts to unit holders for tax purposes and the exercise of the power does not materially change the value of the units held by the relevant unit holders. An impact rating of “unfavourable” would attach to this replacement example – which clearly covers circumstances in which the common discretion is exercised for the purposes of tax mischief and not merely in the course of good trust administration.

## **8. Addressing more clearly the four categories of trusts**

Unit trusts can be broadly classified into four categories, namely:

- a) A publically listed MIS.

- b) A registered MIS.
- c) An unregistered MIS.
- d) All other Unit Trusts.

We believe the practical application of the PCG would be enhanced if the four circumstances identified by in the summary table of the draft PCG were applied to the four categories of unit trusts highlighted above.

## **9. Fiduciary responsibilities for unregistered wholesale schemes**

It is important that the finalised PCG clarify when an unregistered scheme will be able to meet the requirements of the PCG. We do not believe it is possible for the majority of these types of trusts to be able to obtain an appropriate level of comfort from the PCG.

It is very common that a trust deed for an unregistered scheme has wide discretionary powers. However, in our experience, it is uncommon for these powers to be exercised where one or more of the following is present:

- a) The fund is operated by an AFSL holder.
- b) An Information Memorandum (“IM”) has been issued to the members of the fund.
- c) There are unit holders that are not related to the operator of the fund.
- d) There are unit holders that are not related to other unit holders of the fund.

We are of the opinion that there are adequate fiduciary responsibilities that are placed on the trustee that should weigh in favour of the Commissioner exercising his discretion. We therefore suggest the following changes to the draft PCG be made:

- a) Paragraph 18, dot point 1, should be expanded to include the fiduciary responsibilities of a trustee of an unregistered MIS where the trustee is an AFSL holder.
- b) Paragraph 18, dot point 4, should also refer to an Information Memorandum of an unregistered MIS.
- c) Examples 8 and 9 should clarify how this is satisfied by an unregistered MIS and should also link back to the comments in paragraph 18.

## **10. The trust deed or Information Memorandum contains determined (but variable) returns**

There are occasions where different classes of units are issued by a unit trust providing for preferred returns to one class over another (up to a certain limit). While the rights are fixed, the proportionate share of income and capital depends on the income and capital generated from year to year. For example, if the first 8 per cent return is to be paid to Class A unit holders (calculated on the amount of unit capital subscribed), this could equate to 100 per cent of the income for a period or could equate to 10 per cent.

We understand that historically the ATO have taken the view that non-proportionate changes to income and capital percentages can result in the trust not being considered fixed.

We believe it is important to clarify in the PCG that it is possible for a trust to be considered fixed where entitlements are “fixed” in quantum or in proportion. Accordingly, where the trust deed (read in conjunction with the Information Memorandum if applicable), contains stipulated rights relating to classes of units, those rights can still be treated as fixed entitlements for the purpose of the provisions even if the proportions may change depending on the levels of income.

#### **11. Requirements of an Information Memorandum**

Further to the analysis above concerning the fiduciary responsibilities of unregistered schemes, the PCG should clarify the fixed trust status of an unregistered MIS and the impact of their commitments to which they adhere in their Information Memorandums.

#### **12. Single class of units where different fees are charged**

Example 2 of the draft PCG outlines that a trust with a single class of unit holders will (without more) weigh in favour of being treated as a fixed trust by the Commissioner.

We believe that this should be expanded to include trusts that have multiple classes of units on issue, where the only difference in the class relates to fees being charged to the Fund.

Such reasoning would be similar to the rules which apply to AMITs under s 276-15 of the ITAA 97, which provide that fees imposed by a trustee to its members are disregarded in assessing whether members have the same entitlements to income and capital.

#### **13. Non-definitive nature**

An important aspect of the PCG that should be improved is that it is written to be non-definitive. For example, the draft PCG reminds the reader that there are many factors in play, and individual factors only ‘weigh towards ...’ a position, and that a view might be abandoned ‘in exceptional circumstances’. Readers cannot take too much comfort in the PCG given these caveats and cautions.

For example, Example 1 says if units in a trust are listed, the ATO will treat the trust as a fixed trust unless there are ‘exceptional circumstances ...’ Given that these trusts will most likely be AMITs, this is not especially helpful as they are likely to be already deemed to be fixed trusts. But even if a trust wasn’t an AMIT, it is hard to understand why the ATO wants to be equivocal about a listed unit trust.

Ideally, the PCG should provide a clear safe harbour or self-determination without negative consequences, so that if the trust deed satisfied the favourable criteria and none of the unfavourable criteria, the trust could safely assume it was fixed. This would provide certainty to taxpayers. However, this would be difficult at present given the dearth of favourable factors, and as such a re-examination of the characterisation of the factors included in the table in the PCG would be needed. For example, where the trustee’s power to amend the terms of the trust is fettered to preclude powers to reduce unitholders’ / beneficiaries entitlements, this is regarded as a neutral factor but may be better regarded as ‘favourable’ to the exercise of the Commissioner’s discretion.

Should the ATO prefer to retain the caveats that a particular view may be abandoned ‘in exceptional circumstances’, then we suggest that the PCG includes detailed commentary in relation to what would constitute such ‘exceptional circumstances’ (for example, where there is clear evidence of structuring trust ownership a particular way with the primary objective of tax avoidance). Practical examples of the ‘exceptional circumstances’ that would void the ATO’s default position should accompany the commentary. This would provide much more

practical guidance and certainty to taxpayers than the current vague and non-committal wording

**14. Procedure – Commissioner’s discretion**

It would be useful if the PCG clarified the following:

- i) How the Commissioner’s discretion will be exercised (e.g. whether a taxpayer needs to get it in writing, whether it can be obtained only by application for a private ruling or in other ways, and any significant internal ATO processes which a taxpayer may expect to be a prerequisite to getting an exercise of the discretion); and
- ii) What rights a taxpayer has against an unfavourable exercise of the Commissioner’s discretion (or other avenues (and if so, what) are suitable instead, including internal ATO reviews if applicable, but also whether this is a subject for which the normal process to object to the Commissioner’s decision should be followed).

## APPENDIX

### Taxation of superannuation entities - Fixed entitlement - Non-arm's length income rule (NALI)

Paragraph 3 of the PCG states that it does not apply for the purposes of the 'non-arm's length income' rules in section 295-550 of the ITAA 1997 or the 'special income' rules in the former section 273 of the ITAA 1936. Rather the Commissioner's view of "the concept of fixed entitlement in those circumstances is set out in Taxation Ruling TR 2006/7 *Income tax: special income derived by a complying superannuation fund, a complying approved deposit fund or a pooled superannuation trust in relation to the year of income*".

The Commissioner view is that the discretion in 272-5(3) of Schedule 2F to the ITAA 1936 cannot be applied to the meaning of "fixed entitlement" in the context of the NALI definition under section 295-550 ITAA 1997 (former section 273 of the ITAA 1936). See TR 2006/7 and the decision impact statement to *The Trustee of MH Ghali Superannuation Fund v Commissioner of Taxation* ("MH Ghali").<sup>1</sup>

The Commissioner contends that:

- The definition of "fixed entitlement" under section 295-550 of the ITAA 1997 is undefined and its meaning is therefore to be determined through ordinary principles (paragraph 206 TR 2006/7).
- The term "fixed entitlement" is not defined in section 6 of the ITAA 1936 and there is nothing in the former section 273 of the ITAA 1936 to indicate that the Schedule 2F definition of fixed entitlement applies.

It is noted that the decision in the AAT in *MH Ghali* takes a different view.

In our opinion, the rewrite of the provisions into Division 295 means that the Commissioner should now be able to apply the discretion. "Fixed entitlement" is defined in section 995-1 of the ITAA 1997 as having the same meaning prescribed in Schedule 2F of the ITAA 1936 and, unless a contrary intention is evident, that meaning should prevail.

Consistent with section 950-110(2) of the ITAA 1997, the mere absence of an asterisk next to "fixed entitlement" under section 295-550 of the ITAA 1997 does not mean that one does not have regard to definitions under section 995-1 of the ITAA 1997 when ascertaining the meaning of a term.

Accordingly, in our view, the ITAA 1997 is to be applied having regard to the definition of fixed entitlement contained in the dictionary. The dictionary defines a fixed entitlement as follows:

*"fixed entitlement" : an entity has a fixed entitlement to a share of the income or capital of a company, partnership or trust if the entity has a fixed entitlement to that share within the meaning of Division 272 in Schedule 2F to the Income Tax Assessment Act 1936.*

We highlight that the Commissioner has the ability to be able to read the provisions in the above manner, which may not have been available under the ITAA 1936. We recommend that the Commissioner reconsider his position on this matter.

---

<sup>1</sup> [2010] AATA 527