TAXATION INSTITUTE OF AUSTRALIA

NSW DIVISION

27 – 29 November 2003
Crowne Plaza, Terrigal NSW

"Don't Burn Your Losses" 2003 NSW ANNUAL INTENSIVE RETREAT Losses & Trusts – Private

Written by/Presented by:

By Robert Gordon
St James Hall Chambers, Sydney

For the Taxwise® Professional

"DON'T BURN YOUR LOSSES"

TAXATION INSTITUTE OF AUSTRALIA

2003 NSW ANNUAL INTENSIVE RETREAT

SESSION 5 LOSSES & TRUSTS – PRIVATE[1]

By Robert Gordon[2], St James Hall Chambers, Sydney

Introduction

It is immediately apparent that the description of trusts as "private", in distinction to "public", is to transpose those terms from the arena of companies[3], as they are not terms which appear in the law of the taxation of trusts.

Broadly, a company is a public company for tax purposes if it is listed on a stock exchange[4], or is the subsidiary[5] of such a company. Naturally it is much more complicated than that but for present purposes it suffices as a broad overview. For tax purposes (as contrasted with Corporations Act purposes) in a particular year a private company is any company that is not a public company. Section 103A and related provisions provide a set of rules for determining whether a company is a public company. The test is applied on a year by year basis. In relation to losses, perhaps the main distinction between the two types of companies, is the assumption of continuity of ownership of a public company that is not subject to a takeover or in which there has not been "abnormal" trading in its shares[6].

The trust loss measures were introduced with effect from 9 May, 1995 in Schedule 2F of the 1936 Act to deal with trust loss trafficking and the transfer of the tax benefit of losses to persons who did not bear the economic loss when the tax losses were incurred by the trust. The company tax loss measures where introduced many years before to deal with the same issues[7].

The Starting Point - Categorisation of Trusts as Fixed Trusts or Non Fixed Trusts

The main distinction between types of trusts for tax loss purposes, is whether the trust is a fixed trust or non fixed trust.

[1] Disclaimer: This paper does not constitute advice. It should not be relied on as such. If in doubt professional advice should be sought from an appropriately qualified adviser.
[2] I wish to acknowledge David Williams' assistance in reviewing this paper.
[3] Div 7 of the 1936 Act
[4] s103A(2)(a) of the 1936 Act
[5] s103A(4) of the 1936 Act
[6] s166-5(2) of the 1997 Act
[7] now in Divs 165 & 166 of the 1997 Act

Similarly to the way a private company is defined to be a company that is not within the definition of a public company[8], a “non fixed trust”[9] is defined to be a trust that is not a “fixed trust”.

A fixed trust is one the interests of the beneficiaries of which is “vested and indefeasible”[10].

In more common parlance, a unit trust might often have been thought to be an example of a fixed trust whereas the classic non fixed trust is the discretionary trust, normally used by families.

As the paper by Karen Rooke entitled *“Fixed and Non-Fixed Trusts”* given to the 2000 NSW Intensive Seminar of the TIA pointed out, as the definition of “fixed trust” revolves around the concept of “vested and indefeasible” interests, the legal effect is that careful analysis of the trust deed is required, and even thereafter, there will often be considerable doubt whether a particular unit trust will be a fixed trust or not[11].

At the time that paper was written the concept of fixed trust was assuming even more importance than it has just for the issue of trust losses, due to the draft legislation for the implementation of an “entity” taxation regime[12], to tax non fixed trusts as companies[13]. Of course, that proposal has been shelved, but will no doubt make a come back in due course[14].

Almost invariably, a discretionary trust will be “closely held” in the sense that its controllers will be a small number of people (often just one) and be used for the benefit of the family and associates of that controller(s). Exceptions may include trusts controlled by large professional practices or by public companies but this needs to be checked in every case.

For tax loss purposes[15], fixed trusts are categorised into:

1. ordinary fixed trusts;
2. listed widely held trusts[16];
3. unlisted widely held trusts[17];
4. unlisted very widely held trusts[18]; and
5. wholesale widely held trusts[19].

[8] s103A(1) of the 1936 Act
[9] in s995-1 of the 1997 Act
[10] see s995-1 of the 1997 Act definition of “fixed trust” cross referenced to “fixed entitlement” in s272-5(1) of Sch 2F
[11] Except where the saving provisions of s272-5(2) & (3) of Sch 2F apply; also see PS2002/11
[12] New Business Tax System (Entity Taxation) Bill 2000
[13] Indeed, worse than companies. Had all it done been to tax similarly to companies, it probably would have been enacted.
[14] Treasurer’s Press Release of 27/2/01 (No. 008 of 2001)
[15] Prior year losses, current year losses (Div 268 of Sch 2F), & debt deductions
[16] s272-115 of Sch 2F
[17] s272-110 of Sch 2F
[18] s272-120 of Sch 2F
[19] s272-125 of Sch 2F

The legislation effectively proceeds based on an assumption that a significant number of unit trusts will qualify as fixed trusts. As indicated above, this assumption is potentially a misplaced one, which leaves one between a rock (you must treat all trusts as non fixed trusts and satisfy those tests as best as possible, even though they are not directly appropriate) and a hard place (treat the unit trust as a fixed trust and rely on the ATO not challenging the assumption if the matter of the treatment of the loss ever becomes disputed).

Whilst the trusts created under a will are often fixed trusts, they are usually "excepted trusts"[20] to which Schedule 2F does not apply, and so the most common example of fixed trusts that needs to be considered in tax practice as it relates to tax losses, is the unit trust. Indeed, when the requirements of the four types of widely held trust are considered, it is apparent that such trusts are necessarily unit trusts.

A unit trust is "widely held"[21] if it is not "closely held".

A trust is "closely held" if 20 or fewer individuals between them hold directly or indirectly and for their own benefit 75% or more of the fixed entitlements to income or capital of the trust. A unit trust in which all units are owned by non fixed trust will also be within the definition[22]. This test mirrors one of the tests in section 103A in relation to the status as a public company for tax purposes.

As the focus of this paper is on losses and "private" trusts, it is only necessary to observe that tests for continuity of ownership/control for widely held trusts, like public companies for tax purposes, involve "abnormal trading" tests[23], and in the case of listed widely held trusts, also like companies generally[24], allows for a "same business test". This test is not available to any other type of trust[25].

The third main category of trusts for tax loss purposes, it the "excepted" trust[26]. These are complying super funds, PSTs, complying ADFs, deceased estates (administered within five years of the date of death), and trusts that elect to be treated as "family trusts"[27].

As "private" trusts are often for the benefit of one family, the merits of making a family trust election for such a trust is an important consideration in this paper. As a common vehicle for a few unrelated individuals or families to co-operate is an ordinary unit trust which is therefore "closely held" and is also a "private" trust, issues associated with tax losses of those unit trusts will also be considered.

My research has not revealed any reported cases involving the provisions of Schedule 2F, nor have there been no public rulings involving the provisions of Schedule 2F. However, there have been a number of ATO IDs, which are footnoted.

---

[20] If wholly administered within five years of the date of death: s272-100(c) of Sch 2F
[21] 272-105(1) of Sch 2F
[22] s272-10(2)-(4) of Sch 2F; note the parallel with s103A(3) for companies
[23] SubDiv 269 of Sch 2F
[24] SubDiv 165-E of the 1997 Act
[25] s269-100 of Sch 2F
[26] s272-100 of Sch 2F
[27] and fixed unit trusts if all of the direct and indirect fixed entitlements to income and capital are held by bodies exempt under s23 of the 1936 Act or Div 50 of the 1997 Act: s272-100(d) of Sch 2F

Corporate Unit Trusts and Public Trading Trusts

Whilst corporate unit trusts and public trading trusts are taxed as companies under Divisions 6B and 6C of the 1936 Act, respectively, their tax losses are not dealt with under the company tax loss provisions, but rather under the trust loss provisions of Schedule 2F of the 1936 Act.

However, as those trusts are "widely held", no further consideration will be given to them in this paper.

Bad Debt Deductions

Schedule 2F also deals with debt deductions of trusts, but only from 20 August, 1996.

These are deductions under s51 or s63 of the 1936 Act, or s8-1 or s25-35 of the 1997 Act, for writing off the whole or part of a debt as bad, or under s63E(3) or (4) of the 1936 Act in respect of a debt/equity swap relating to the whole or part of a debt.

For fixed trusts (that are not excepted trusts) to be entitled to such debt deductions[28], it is necessary that the trust either meets the (more than) "50% stake test" or the alternative test (where fixed interests in a head trust are owned by non fixed trusts).

For non fixed trusts (that are not excepted trusts) to be entitled to such debt deductions, it is necessary that four conditions in s267-25(2) of Schedule 2F and two further conditions in s267-65 of Schedule 2F, be met.

Change of Ownership

It is fundamentally important to note that due to the perceived difficulty of ensuring that a discretionary trust continues to be "owned" and controlled by the same group, there is no discretion to treat such a trust as meeting the continuity of ownership test (COT) even in circumstances where there is no suggestion that its "ownership" and control has changed[29], which is the reason for the tax loss rules in the first place. The absence of such a provision is harsh and appears to represent a long standing attitude on behalf of the ATO[30] that discretionary trusts are only vehicles for tax avoidance[31].

In acknowledgment of how the COT for trusts was handled before Schedule 2F, that is, more like in relation to the old s160ZZS "majority underlying interest" test[32] was applied to determine whether pre CGT trust assets had been deemed to become post

---

[28] s266-35 of Sch 2F
[29] Even though the machinery to do so exists, in relation to "family trusts" by virtue of the need to have "family control" (s272-80(4)) as defined in s272-87, and in the integrity measures where the Commissioner can deem control by a particular group not to have been maintained, or to have been maintained but only when a person dies or there is a marriage breakdown: s269-95. Also see s267-40(3) and s267-75(3) of Sch 2F
[30] And the Treasury as a result of the recent transfer of policy function and personnel from the ATO
[31] The high water mark of which was the introduction of the unnecessary "ultimate beneficiary" provisions of Div 6D of the 1936 Act
[32] rewritten as s149-30 of the 1997 Act

CGT assets, the ATO issued TD2000/27, which stated[33] that the old approach would continue to apply to assume the COT was met for the years before Schedule 2F was introduced if:

- the trustee has administered the trust for the benefit of members of a particular family at all times during the relevant years of income; and
- the trustee has not exercised discretionary powers to appoint beneficiaries or amend the trust deed, the practical result of which was to effect a change of 50% or more in the underlying interests in the trust assets.

For an ordinary discretionary trust, as no "mere discretionary object" has a fixed interest in the income or capital of the trust[34], and any "takers in default" have only an interest liable to be divested by the exercise of a power of appointment, there will not be any fixed interests in the trust, let alone a more than 50% continuity in the ownership of such interests as it required to satisfy the COT for trusts[35].

Thus for an ordinary discretionary trust for the benefit of one family, unless the trust makes a family trust election, the only other way it can satisfy the COT is for it to pass the "pattern of distribution test"[36]. Broadly speaking this test will only be passed if more than 50% of the distributions of income and capital have been to the same individuals in up to six years preceding application of the test, starting with the first year in which a distribution took place[37].

If no distributions have been made, for instance as tax losses have been incurred from inception, and therefore there has been no distributable income, the "pattern of distribution test" is irrelevant[38], and so it cannot be relied on to satisfy the COT.

Accordingly, for a discretionary trust for the benefit of one family to be able to deduct its prior year tax losses, if it does not make a family trust election, it will be very important to ensure that the distributions of income and capital meet the "pattern of distribution test"[39].

For a unit trust whether or not it is within the definition of a "fixed trust", if it is owned and controlled only by members of one family, it will be entitled to elect to become a family trust, and if it does so, it will meets the COT.

The common example of a unit trust, all the units in which are owned by a discretionary trust will not be usually be entitled to make a family trust election, as it will be unlikely that the discretionary trust deed will limit by its terms, only family individuals to obtain the benefit of enjoyment of income and capital, as is required[40]. Of course if the discretionary trust has made the family trust election, the unit trust in

[33] At para 13
[34] Gartside v IRC [1968] AC 553
[35] The (more than) "50% stake test" is contained in s269-55 of Sch 2F, but also see the alternative test in s266-45
[36] s269-60 of Sch 2F
[37] s269-65 of Sch 2F
[38] s269-65(1) of Sch 2F; also see ATO ID2003/174
[39] The "pattern of distributions test" does not apply for current year loss purposes or, in the case of debt deductions, where the debt is incurred in the income year in which the deduction arises
[40] s272-87(1)(c) & s272-87(2)(g) of Sch 2F

which it owns all the units will meet the COT as the family trust is deemed to be an individual and the unit trust will meet the (more than) "50% stake" test[41].

However, if units representing 50% or more of the units on issue in the unit trust are themselves held by discretionary trusts which have not elected to become a family trust (or do not pass the "pattern of distributions test"), the unit trust cannot meet the COT.

Accordingly, for a normal situation of a 50:50 joint venture of two families using discretionary trusts for each family, holding units in a unit trust 50:50, if only one of the discretionary trusts has made a family trust election, the unit trust cannot pass the COT, on the basis that the (more than) "50% stake" test is failed. The alternative test in s266-45 cannot apply as one of the discretionary trusts is a family trust and so "the "first condition" of s266-45(2) cannot be met.

If both discretionary trusts make family trust elections, then the (more than) "50% stake" test will be passed[42] and the unit trust will pass the COT.

If neither of the discretionary trusts makes the family trust election, the alternative test in s266-45 may apply if each discretionary trust passes the "pattern of distributions test", notwithstanding that neither trust has a more than 50% interest in the unit trust, as the alternative test relies on an exact 50% test. It seems strange that where neither trust has made a family trust election, this could give the unit trust the chance to meet the COT which is not available if only one trust has made the family trust election.

This is an area which has opened up new possibilities for a professional advisor getting it wrong. In particular, it seems that it cannot be assumed that a unit trust structure is an acceptable arrangement where there is a prospect of losses arising unless the parties are aware of the complications flowing from the operation of these provisions. *Prima facie*, it would be necessary to ensure that each of the unit holders makes the required family trust election and that any new unit holders (either by transfer or by allotment of new units) are in a similar situation. I am not aware of this being a matter that is routinely addressed at the time of establishing a unit trust structure for use by private groups[43], which may potentially lead to professional negligence claims.

The introduction of the small business roll-over relief in Division 152 of the 1997 Act has had the effect of having individuals own the units in unit trusts (under the $5M threshold) to a greater extent than in the past (when invariably a discretionary trust would been a unit holder), so that one or two individuals can be a "controlling individual", in an attempt to take the maximum relief potentially available under that Division.

[41] s272-30(2) of Sch 2F

[42] As each family trust is treated for the purpose of the (more than) "50% stake" test as though it was an individual: s272-30(2) of Sch 2F

[43] Neither have I seen any movement to company structures as a result of these complexities with unit trusts

The technicalities of Schedule 2F are such that it would have been useful for there to have been a *de minimus* test such as applies with the 45 day holding rule and franking credits[44].

Variations to Deeds Causing Creation of a New Trust

It is a basic tenet that it is only the person that incurs a tax loss that can subsequently use that tax loss. It follows from this that for a trust estate to be able to claim losses it must be the same trust estate that incurred the losses. Hence, if there is the creation by resettlement or otherwise of a new trust estate, losses incurred by the trust estate that incurred the losses should not be available on a go forward basis. This is similar to the position where an individual who has carry forward losses dies. The estate of that person is not entitled to the benefit of the losses. They are lost.

Therefore, perhaps an even bigger problem for the use of tax losses by trusts is the Commissioner's attitude to "resettlements" as most recently express in his so called "Creation of a new trust - Statement of Principles" of August, 2001.

I set out the relevant parts of the Statement of Principles discussing general principles below, and extract some of the parts dealing with specific situations as Appendix One.

On page 1:

"The decision of the High Court in Commissioner of Taxation v. Commercial Nominees of Australia Ltd *[2001] HCA 33 was a case involving a superannuation fund established by a deed of trust in which the Tax Office sought guidance from the Courts as to the circumstances in which changes made to a trust alter the nature and character of the trust relationship such that the original trust (and thus, the original taxpayer/entity) ceases to exist and a new trust (that is, a new taxpayer/entity) is created. A number of tax consequences arise if a new trust is created.*

The Australian Tax Office (ATO) has been seeking to clarify when changes to a trust are such that for income tax purposes one trust estate comes to an end to be replaced by another. For convenience these situations are sometimes referred to as 'resettlements', although resettlements in the technical sense may be only one way in which such terminations occur. The consequences of terminating the trust can include:

- *realisation at trustee level of the trust property, and the loss of carried forward tax benefits; and*

- *disposal by beneficiaries of their interests and an acquisition of interests in the new trust.*

In other situations, although the original trust estate may continue, changes may lead to the creation of one or more new and separate trust estates for tax purposes.

[44] s160APHT of the 1936 Act. The *de minimus* provisions for FIFs also come to mind: s515 of the 1936 Act

…The decision of the High Court in Commercial Nominees *provides guidance in relation to changes made to superannuation entities. However, nothing that the High Court said is contrary to the principles stated here and the Commissioner will continue to apply this Statement of Principles in relation to changes made to other categories of trust estates. The statement is intended for general guidance and* _**is not a public ruling**_ *for the purposes of the* Tax Administration Act*…"* (underlining added)

It should be observed, the Statement of Principles of August, 2001 is in almost identical terms to a previous Statement issued on 9 June, 1999. I note that for some time before the 9 June, 1999 the Commissioner had an "embargo" on issuing private rulings concerning the subject matter[45]. For criticism of the previous Statement, see Ada Moshinsky QC "Trust Taxation: Trust Resettlements" The Tax Specialist Vol 3 No 3 Dec 1999 and Lister Harrision QC "Trust Resettlements: The Commissioner's flaws of reasoning" The Tax Specialist Vol 3 No 2 Oct 1999.

The Commissioner sought to establish his view as the law by promoting the *Commercial Nominees* case as a "test case", but when the High Court did not oblige, the Commissioner reissued his 9 June, 1999 Statement with the only change being to deny that the High Court's decision in *Commercial Nominees* was relevant. In the circumstances, the fact that it has not issued as a public ruling perhaps reflects that the "Rulings Panel" may not have thought the Statement was supportable at that level?

On page 3:

"Trust settlements are recognised under Australian State stamp duty legislation and have generated extensive case law on when a trust is 'settled' or 'resettled'. Relevant decisions include Davidson v. Armytage (1906) 4 CLR 205, Davidson v. Chirnside (1908) 7 CLR 325, CSD (NSW) v. Perpetual Trustee Company Ltd (Quigley's case) (1926) 38 CLR 272, Wedge v. CS (Vic) (1940) 64 CLR 75, Buzza v. CS (Vic) (1951) 83 CLR 286 and CSD (NSW) v. Buckle 98 ATC 4097.

The stamp duty cases indicate that a new settlement arises when the changes amount to a 'new charter of rights and obligations', or there are 'created in the trust fund as a whole different equitable interests to those which had existed under the pre-existing trust'. In the ATO's view there is considerable overlap between the terms 'settlement' and 'trust estate'. Exceptions include bare trusts (which may not be settlements) and multiple trust estates arising under one instrument (which may comprise a single settlement). Nonetheless, these cases give valuable insights into the nature of trusts and the circumstances in which new trusts arise." (underlining added)

On pages 3-4:

[45] See para 13 of TD2001/26 as an example of the Commissioner's application of his 1999 Statement. In contrast, see the TIA Technical Director's report in Taxvine Newsletter 2003 No.34 (5/9/03) about amending trust deeds to exclude charities for Div 152 purposes, that the Commissioner would not regard the trust as being resettled. Also see CR2003/47 issued with reference to his 2001 Statement. I have recently been involved in an application for a private ruling that the Statement not apply, which has taken 13 months and several promptly answered queries, to obtain an unfavourable ruling. I suspect the ATO is not anxious to have this area of the law litigated

"... A line of cases, discussed and explained in Re Weir's Settlement [1970] 1 All ER 297, considered when changes to a trust which took place in consequence of a death would result in a 'passing' of the trust property. Weir's Settlement supports the proposition that property passes where changes amount to a 'new trust in favour of a new group with new qualifications', as opposed to a situation where the 'same trust purpose or theme continues unchanged'. (underlining added)

In the ATO's view both the stamp duty and estate duty cases indicate that a new trust arises when there is a fundamental change to the trust relationship. It is a change in the essential nature and character of the original trust relationship which creates a new trust. This may mean that the original trust ceases to exist, and a new trust arises. Alternatively, a new trust may arise which exists independently of the original trust.

Changes potentially leading to a new trust can arise by several means, including variations under a power in the deed and a variation by agreement among the beneficiaries. Listed below are some of the changes which raise the question of whether a new trust has been created.

- *any change in beneficial interests in trust property;*
- *a new class of beneficial interest (whether introduced or altered);*
- *a possible redefinition of the beneficiary class;*
- *changes in the terms of the trust or the rights or obligations of the trustee;*
- *changes in the nature or features of trust property;*
- *additions of property which could amount to a new and separate settlement;*
- *depletion of the trust property;*
- *a change in the termination date of the trust;*
- *a change to the trust that is not contemplated by the terms of the original trust;*
- *a change in the essential nature and purpose of the trust; and/or*
- *a merger of two or more trusts or a splitting of a trust into two or more trusts.*

Depending on their nature and extent, and their combination with other indicia, these changes may amount to a mere variation of a continuing trust, or alternatively to a fundamental change in the essential nature and character of the trust relationship. In this second case, the original trust is brought to an end and/or a new trust created.

Whether a new trust is created will depend, among other things, on the terms of the original trust, and on the powers of the trustee. The original intentions of the settlor must be considered in determining whether a new trust has been created. There may be different trigger points/tests for different types of trusts. (underlining added)

Commercial Nominees

In the Full High Court in *FCT v Commercial Nominees of Australia Limited* (2001) 47 ATR 220, a superannuation trust was established in 1988 for the employees of the Miden Group of companies. In 1993 significant changes were made to the trust deed. These included changing the nature of the members' benefit entitlements, appointing a professional management company to administer the trust, creating a new "C" class of members and permitting the superannuation scheme to be promoted to the public.

The Commissioner of Taxation contended that the 1993 amendments, taken as a whole, constituted a resettlement that created new trusts so that there was insufficient identity between the trust that had incurred losses in 1989 and 1990 and the trust that derived the income in 1995. The taxpayer contended that the fund was a continuing fund at all material times and, accordingly, the losses were deductible. The High Court held for the taxpayer.

At 227 it was said:

[35] <u>The full court of the Federal Court considered what it described as the resettlement analysis and concluded that, far from there having been a fundamental change in the nature and incidents of the trust relationship, a comparison of the old and new arrangements indicated that they were essentially the same</u>. The fund continued to provide benefits for some employees or former employees of the Miden Group. The capacity to admit to participation in the fund employers of companies unrelated to the Miden Group had existed from the outset. The problem, however, is that a judgment as to what is "essential", in this context, largely turns upon the level of generality or particularity at which the changes are considered. At one level there was, at all material times, a complying superannuation fund, established to provide employee benefits, which were potentially available to employees or former employees of the Miden Group and others. At another level, what had originally been a defined benefit fund intended, for practical purposes, at least mainly for Miden Group employees, became a public offer fund providing accumulation benefits. There is nothing in Pt IX of the ITAA 1936 which provides a criterion by reference to which it is possible to decide whether such changes are essential or inessential, fundamental or immaterial.

[36] As the full court, and the Administrative Appeals Tribunal held, the question is one of continuity, to be considered in the context of a superannuation fund which, of its nature, may be expected to undergo change. The question is whether the eligible entity which derived the taxable income in the year ended 30 June 1995 is a different entity from the eligible entity that incurred losses in the earlier years. <u>If, as the appellant contends, it is a different entity, there is a question as to what happened to the original entity</u>. The 3 main indicia of continuity for the purposes of Pt IX are the constitution of the trusts under which the fund (if a trust fund) operated, the trust property, and membership. Changes in one or more of those matters must be such as to terminate the existence of the eligible entity, or to produce the result that it does not derive the income in question, to destroy the necessary continuity. The trusts under which the fund operated in 1994-1995 were constituted by the original trust deed in 1988 as varied by the exercise, in 1993, of a power of amendment. The property the subject of the trusts did not alter at the time the amendments took effect. Persons who were members of the fund before the amendments remained members of the fund after the amendments. The fund, both before and after the amendments, was administered as a single fund, and treated in that way by the regulatory authority.
(underlining added)

Whilst the High Court did not need to express a view on trusts generally, it is significant that that the Full Federal Court did not think there was a resettlement in the *Commercial Nominees* case, and the High Court did not conclude that they were wrong on that point, but that the case could be decided by looking only at the continuity of the superannuation trust for Part IX purposes.

Certainly, the question the High Court asked in *Commercial Nominees*: "*If, as the appellant contends, it is a different entity, there is a question as to what happened to the original entity*", is often apposite.

There must be serious doubt as to the appropriateness of the concept of "resettlement" in the context of capital gains tax for a unit trust, as the units themselves are treated as CGT subject assets, like shares in a company, and a variation of the rights attaching to shares does not affect the company's ownership of the company's assets. There is a serious double tax implication for the unit holders if that is not the case, which is of course why Taxation Determination TD2000/32 was issued.

TD 2000/32 poses the question: *"Income tax: capital gains: for capital gains purposes is the unit held by a unit holder in a unit trust the relevant CGT asset?",* which is answered:

"1. Yes. The unit in the unit trust is the relevant CGT asset irrespective of any interest the unit holder has in the property of the unit trust.

2. The scheme of the Income Tax Assessment Act 1997 is to treat units in a unit trust as the relevant asset for capital gains purposes rather than any interest a unit holder might have in the underlying property of the unit trust.

Note 1 to section 108-5 specifically identifies units in a unit trust as examples of CGT assets."

I deal with the cases on settlements and resettlements in Appendix Two, and note that none of them deal with unit trusts.

The question is always, whether the changes proposed by a deed of amendment extinguish the existing trusts and resettle the trust assets on a new trust. To the extent the Statement of Principles gives specific examples which go further, and say lesser changes can result in a new trust, in my view, is incorrect. A good example of changes to a trust not going that far, is *Buckle*'s case.

<u>*Buckle*</u>

In the Full High Court in *Chief Commissioner of Stamp Duties v Buckle & Ors* (1998) 37 ATR 393, a family discretionary trust was created by a deed of settlement made on 7 August 1991. Under the deed, on the distribution date (ie a date in 2071, or earlier date appointed by the trustee, on which trust assets are distributed to beneficiaries on dissolution of the trust) the trustee was to hold the trust fund for such beneficiaries as he may appoint, or failing such appointment, for such of the children of the original trustee (a son and a daughter), as were alive on the distribution date, in equal shares. The deed included provisions dealing with the event that the children were not alive on the distribution date.

On 11 June 1993, a supplemental deed was executed whereby the deed was amended to the effect that on the distribution date, the trustee was to hold the trust fund for the named children in specified shares (ie one-third for the daughter and two-thirds for the son). The trustee continued to have extensive powers to deal with the trust property in the interim.

The Commissioner of Stamp Duties assessed to duty the unencumbered value of the assets of the trust, some $4 million, as being conveyance of the trust property under s 65 of the Stamp Duties Act 1920 (NSW). At the time of execution of the deed of variation, the discretionary trust had two liabilities which exceeded the value of its assets by $3088.

The Full High Court held that although the supplemental deed affected a conveyance for the purposes of the Act, the interest conveyed was in the remainder of the trust fund at the distribution date. The supplemental deed merely vested interests that before the amendment were contingent.

Taking into account the powers of the trustee, those interests were subject to divestment. Accordingly, only a minimal amount of duty was applicable.

The trustee had a beneficial interest in the trust assets to the extent of its rights to be indemnified out of those assets against personal liabilities incurred in the performance of its duties as trustee. This beneficial interest of the trustee will be preferred to the beneficial interests of the beneficiaries. This was not an encumbrance which the Act requires to be disregarded. That the interest conveyed has no value does not depend on treating the trustee's beneficial interest as an encumbrance, but that the trustee's interest is preferred.

At 401 it is said:

[37] In the present case, under the deed of settlement as it stood before the supplemental deed, no interests in corpus had vested. The trust fund was vested in the trustee, impressed with such trusts as were created by or pursuant to the deed of settlement. There was no hiatus or gap as to any outstanding beneficial interest in the trust fund. The assets comprising the trust fund were not impressed with trusts which gave rise to equitable interests therein which were so extensive as to leave the trustee with no more than the bare legal title. The trustee might accurately be described as the owner of those assets, but as subjected to the equitable obligations imposed by the deed of settlement. The second and third respondents had no vested interests in corpus but they did enjoy rights to due administration of the trusts of the deed of settlement which a court of equity would protect.

[38] More assistance in the present appeal is provided by a decision upon s 66 of the Act in Comr of Stamp Duties (NSW) v Perpetual Trustee Co Ltd (1926) 38 CLR 272 (Quigley's case). The settlor, Mr Quigley, had vested interests under certain settlements. These included undivided moieties under two settlements. One moiety was subject to a life interest in Mr Quigley's stepmother. All of his interests he then settled by deed dated 16 November 1925 on trust for himself for life with remainder to other persons. …he settled the whole of his interests under the earlier settlements and thereby created a new life interest. What was valued was the whole of the interests settled in 1925. These were the relevant property upon which s 66(1) operated. <u>The property was not the whole of the assets of the earlier settlements in which Mr</u>

Quigley held his interests. (underlining added)

The Chief Commissioner of Stamp Duties approach in *Buckle*'s case is similar to the Commissioner of Taxation's in the Statement of Principles, as it is the gross value of the assets to which each seeks to attach. The changes made by the supplemental deed in *Buckle*'s case were not labelled a resettlement by the High Court. There was no new trust created[46], which is in my view the test of whether a variation to a trust instrument, will trigger a disposal by the existing trust in favour of a new trust.

None the less, the High Court's approach in *Buckle*'s case is totally ignored[47] in the August, 2001 Statement of Principles, and therefore casts considerable doubt on the conclusions the Statement draws in relation to capital gains tax, as does the failure to properly address the Commissioner's lack of success in *Commercial Nominees*, which he regarded as a test case on the tax loss issue.

Family Trust Election – state of play

For a discretionary trust for a family to be able to use its tax losses, it will either have to make a family trust election, or pass the "pattern of distributions" test.

Also, as the structure of a discretionary trust owning all the shares in a private company has, at least in the past been very common, and as the private company will not meet the COT[48] if the trust cannot meet the COT itself, in order the company to be entitled to use its tax losses, the discretionary trust will invariably need to consider making a family trust election if it cannot or does not what to meet the "pattern of distribution test".

Further, for discretionary trusts that have acquired shares in companies since 31 December, 1997 which shares pay franked dividends, unless the discretionary trust makes a family trust election if it cannot or does not what to meet the pattern of distribution test, the dividends will not be treated as franked[49].

Accordingly there are three common reasons to make a family trust election. One reason offered as to why discretionary trusts for a family might not make an election is that it will "limit flexibility". As far as I can tell, this seems to relate to the desire to introduce corporate beneficiaries to reduce the tax rate to 30%. However, there is usually no reason that the corporate beneficiary cannot make an "interposed entity election" and thereby be treated as a "family" member. Put another way, it is only where trust distributions are necessarily going to be made outside the "family", that there may be good reason not to make a family trust election. The other reason offered

---

[46] Also now see Lam & Kym Pty Ltd v Commissioner of State Revenue [2003] VSC 133 (Harper J, Melbourne, 2 May, 2003), where a written declaration (without amending the trust deed), limited within the class of the contingent beneficiaries named in the trust, those persons who could take realty of the trust, and was held not to create a new trust for stamp duty purposes

[47] Although the case is cited in the Statement (at p3)

[48] s165-207 of the 1997 Act; also see ATO ID2003/508

[49] s160APHL(10) applied to 30 June, 2002, but has not yet been re enacted in Div 207 of the 1997 Act, although the intention to do so is apparent from para 10.10 of the EM to the New Business Tax System (Consolidation and Other Measures) Bill (No1) 2002; the relief potentially available through s160APHL(14) is said by the EM to be only for hardship cases

for not want to make the election, is that the ATO may be trying to corral the horses so they can be more easily be shot at a later time!

The main problem is that the election, whilst irrevocable[50], cannot be lodged late if it is not made in the relevant tax return[51], even if there are good and sufficient reasons, and absent any tax avoidance purpose. This must be further evidence of an attitude held by the ATO that the only for the existence of trusts is as vehicles for tax avoidance. The ATO has indicated that they will not regard a family trust election as being lodged in time if there is evidence that the client has given instructions that it is to be made but by mistake, the box has not been ticked on the relevant tax return.

This problem is crying out for legislative amendment. It is reminiscent of the still unfixed but long ago identified issue that there is no ability of the Federal Court to accept an "appeal" out of time[52] although the Administrative Appeals Tribunal has power to accept out of time for good reasons[53]. The frustration apparent with the issue as appear from the minutes[54] of the 26 March, 2003 NTLG meeting, and the ATO's issue of three "fact sheets" on its website in May, 2003 resulted in the TIA putting the matter in its background paper to the Assistant Treasurer for the meeting with her on 18 June, 2003. I attach as Appendix Three the relevant part of the background paper[55]. This background paper makes it clear that the issues are not well known by many advisers.

Income Injection Test

The ability to utilise tax losses in a private group will invariably raise the issue of the "income injection test"[56].

The income injection test is designed to prevent the making use of deductions[57] in an income year, if there is a scheme[58] to take advantage of the deductions.

There will be a scheme to take advantage of deductions in the "basic case"[59] if there is a deduction otherwise allowable to a trust for an income year, and under a scheme, the trust derives an amount of assessable income, and:

- an "outsider"[60] to the trust directly or indirectly provides a "benefit"[61] to the trustee, to a beneficiary, or to an associate[62] of the trustee or beneficiary, and

---

[50] Except if the trust is a fixed trust and a non family member subsequently takes up a fixed interest
[51] See the first sentence of s272-80(2); where no return is required to be lodged, the Commissioner has power to accept a late lodged election: s272-80(2)(b)(ii)
[52] s14ZZN of the TAA; Bayeh v DFC of T 99 ATC 4895
[53] s29(7) of the AAT Act. The bill to create on Omnibus Commonwealth Administrative Tribunal contained the required amendment, but when the bill was not passed, the amendment was not reintroduced.
[54] Item 18
[55] At the inaugural meeting of the NTLG Losses and CGT subcommittee on 7 November, 2003, the issue was again on the agenda (item 15)
[56] s270-10 of Sch 2F which applies to family trusts due to s272-10(1)(d)
[57] Which include carry forward losses: s36-15 of the 1997 Act; Also see ATO ID2003/695
[58] Which s272-140 of Sch 2F provides has the same meaning as in s177A(1) of the 1936 Act
[59] s270-10(1) of Sch 2F
[60] s270-25(1)(c) & (d) of Sch 2F
[61] s270-20 of Sch 2F

- the trustee, beneficiary or associate, directly or indirectly provides a benefit to the outsider (or an associate of the outsider); and

it is reasonable to conclude that the trust derived the scheme assessable income, or

- the outsider provided the benefit to the trust, or
- a benefit was provided to the outsider,

wholly or partly, but not merely incidentally[63], because the deduction would be allowable, and the trust is not an "excepted trust", other than a family trust.

The "special case"[64] involves the outsider becoming the trustee or a person with a fixed entitlement, so the person ceases to be an outside, as part of the scheme.

It is immediately apparent that the making of a family trust election will overcome all Schedule 2F problems with this rule for injections of income from "family" members[65], as they are deemed not to be outsiders[66]. However, Part IVA may still be a problem.

Outcomes

For non fixed trusts that can make a family trust election, the issue in my view, is why you would not make the election rather than the other way around. The difficulties concerning making family trust elections on time, exacerbates the problem.

The issue of whether a particular unit trust is in fact a fixed trust as set out in Karen Rooke's paper, is still with us, although the ATO are now proposing to issue a draft ruling on the issue[67].

The Commissioner's Statement of Principles of August, 2001 also represents a significant risk for tax losses (and for realising currently unrealised gains) in circumstances where it is necessary to make any change to a trust deed[68].

19 November, 2003

---

[62] s272-140 of Sch 2F provides the word has the same meaning as in s318 of the 1936 Act
[63] Note not dominant purpose as required under s177D of the 1936 Act. An incidental purpose is also sufficient to trigger s45B of the 1936 Act
[64] s270-10(2) of Sch 2F
[65] s272-95 of Sch 2F
[66] s270-25(1)(c) & (d) of Sch 2F
[67] As can be seen from agenda items 13 &14 of the NTLG Losses and CGT subcommittee on 7 November, 2003
[68] For instance, many trust deeds were amended in the early nineties to allow income streaming for dividend imputation purposes, due to the issue of TR92/13 where at para 6 it was said that the provision of a specific power to stream would avoid uncertainty about the effectiveness of a resolution to stream dividends, which otherwise would be regarded as rateably distributed

APPENDIX ONE

Extract from ATO document “Creation of a new trust - Statement of Principles August 2001”

5.1. ADDITION OR REMOVAL OF BENEFICIARIES

The identity of those for whose benefit the trust exists is an essential element of the trust obligation and hence the trust relationship. Therefore, changes amounting to a redefinition of the membership class or classes would terminate the original trust. By contrast, changes in the membership of a continuing class are consistent with a continuing trust. In some situations the correct characterisation is unclear but the following examples may assist.

Example 5.1.1
A discretionary trust has as its beneficiaries 'the children and grandchildren of X'. One of the children dies and two new grandchildren are born.

These changes do not terminate the trust. They represent changes in the membership of a continuing beneficiary class.

Example 5.1.2
Another discretionary trust has as beneficiaries 'the children of Y', and anyone else named in the deed as a beneficiary at a particular time. The trustee has a power to nominate beneficiaries, but only if they are parents or grandchildren of Y or their spouses. The trustee nominates Y's mother as a beneficiary.

In this case, the beneficiary group could be characterised as the children of Y and those members of the wider group nominated from time to time. Under this approach there is a mere change of membership and no new trust.

Ordinarily, the ATO will accept that there has been only a change in the membership of a continuing class when:

- an already existing power to nominate new beneficiaries is only exercisable under the terms of the trust in favour of a clearly defined group which it could be reasonably inferred that the trust was intended to benefit; and
- it can be shown from the deed and surrounding circumstances that the actual objective purpose or theme of the trust was to benefit that wider group.

In circumstances where the power to nominate or remove has the broad effect of a power of appointment among a group that the trust is clearly designed to benefit, it is more likely that group can be reasonably characterised as the beneficiary class. In these situations the trustee may benefit the 'inner group' members (those already named in the deed, for instance Y's daughter), by an appointment in their favour. When deciding to benefit the 'wider group' members (such as Y's mother) the trustee first exercises the power of nomination and then, if it so decides, the power of appointment.

In other situations it will be more difficult to characterise all those who may be nominated as beneficiaries as being merely members of a wider beneficiary group. If so, the effect of nominations and removals may be to vary the trust by redefining the group of beneficiaries so that a new trust is created.

Example 5.1.3
A family discretionary trust (which may or not have made a family trust election) has as its beneficiaries members of the X family. The trustee has a power in the deed to nominate new beneficiaries. It may not be exercised in favour of certain persons such as the settlor, but is not restricted to members of the family group and their associates. The power is exercised to nominate members of the Y family as beneficiaries.

In this situation we would conclude that the power of nomination has been exercised to redefine the group of beneficiaries, and thus, to create a new trust.

Example 5.1.4
A 'standard' investment unit trust regularly redeems from, and issues to, investors, units of the same class, or a number of existing classes, on arms' length terms.

The beneficiary class could generally be defined as those who from time to time hold the units under the terms of the trust. This class has an intrinsically changing membership and the issues and redemptions are consistent with a continuing trust estate.

Example 5.1.5
A piece of real estate is owned by the trustee of a 'standard' investment unit trust. X owns all the units and all the shares in the corporate trustee. Both the shares and units are transferred to B. The transfer of units could be direct, or by way of redemption and reissue.

In the ATO’s view the transfer of units, in itself, is consistent with a continuing trust estate for the reasons given in Example 5.1.4 above. In respect of the shares, a change in control of the trustee in these circumstances would be a normal incident in the continuing operation of a trust estate of this type.

This situation can be contrasted with the change in the family discretionary trust in Example 5.1.3. The purpose and essential nature of that trust was to benefit the members of the X family, and a new purpose or theme arose on the change of beneficiaries. By contrast, the unit trust in Example 5.1.5 is for the benefit of those who have subscribed for units and their assignees, and here, no change in that purpose has occurred.

The above comments only apply where the changes in question are not accompanied by other indicia of a new trust. While these features considered in isolation would generally not lead to a new trust, they may form part of an arrangement which does.

Example 5.1.6
A 'standard' investment unit trust is varied to create and issue a new class of units.

Such variations may not only create a new beneficiary group (the holders of the new class) but also may lead to an express or effective change in the rights attaching to the pre-existing class or classes, for instance through introducing a competing claim on the proceeds of the trust fund. The overall result may be a redefinition of the trustee's obligations to the beneficiaries and hence the trust relationship, resulting in the creation of a new trust estate. As noted at the beginning of this statement, tax consequences then arise at both the trustee and beneficiary level.

5.2. EXTENDING THE TERM (DURATION) OF THE TRUST

The trusts under consideration will be established for a defined period, either because of rules against remoteness of vesting or the wishes of the settlor. This statement only covers valid changes to the term of a trust, and not situations where it may purport to continue (perhaps through an oversight) after the date for its termination.

When the term of a trust is extended (say, by exercise of a trustee's discretion or through agreement of the beneficiaries), the ATO needs to consider whether a new trust arises and if so, whether it commences when the variation takes effect or alternatively on the previous termination date. The uncertainty of the law here and the scope for conflicting views is illustrated by the discussion by members of the House of Lords in *Re Holmden's Settlement Trusts* [1968] 1 All ER 148.

Given this absence of clear judicial guidance, the ATO will accept that in most circumstances the mere extension of the term of a trust is consistent with a continuing trust estate. The ATO will reach this conclusion when:

- the trust deed confers an express power to alter the termination date;
- the deed and the surrounding circumstances do not indicate that a particular trust period was a fundamental feature of the particular trust relationship; and
- other accompanying circumstances do not indicate a fundamental change to the trust.

In some trusts, the specified term may be an essential feature whose variation could be a factor pointing towards the creation of a new trust. In these situations the subject matter of the trust can be most accurately described as the income and other benefits arising from the trust property over a particular period.

Example 5.2.1
A trustee holds Blackacre under a trust set up for a ten year term. The beneficiaries of the trust are entitled to the rents of Blackacre over that period. On consideration of the overall circumstances it is clear that it was those ten years' rents, and not just the rents in general or Blackacre itself, that the trust was established to deal with.

Example 5.2.2
A trust is set up specifically as a vehicle for a particular project or to hold an asset of intrinsically limited duration.

If the trusts referred to in Examples 5.2.1 and 5.2.2 were extended, particularly if there were other changes such as the introduction of new investments or activities, it is likely that a new trust would be formed in respect of the new subject matter.

When extending the term of a trust, even in situations when no new trust estate arises, it will be essential to consider the tax consequences for the parties whose interests would have vested in possession on the now varied termination date. The extension of the term could amount to a disposal of these reversionary interests. Furthermore, and particularly in situations where the extension is at the behest of the beneficiaries, consideration will need to be given to the potential application of section 160ZX of the 1936 Act and CGT event E5 under the *Income Tax Assessment Act 1997*.

5.3. CHANGES IN TRUST PROPERTY

In many trusts the property is whatever investments the trustee holds from time to time under its terms. In these situations changes in investments are generally consistent with a continuing trust estate.

Some trusts by contrast may have highly specific subject matter, for instance a trust established for the express purpose of holding a particular asset. In these situations replacing the trust property with other assets may indicate the creation of a new trust.

The relevant principle here is similar to that which we will apply to changes to the termination date: the more specific the subject matter of the trust, the stronger the likelihood that changes to that subject matter result in a new trust estate. Both the terms of the trust and purposes inferred from the surrounding circumstances will be taken into account.

The creation of a trust through a nominal settlement and the later addition of the bulk of the trust property is a long standing practice. In *Truesdale v. FCT* 70 ATC 4056 it was held that a contribution of this type to an existing trust fund did not amount to the creation of a new trust in respect of that contribution for the purposes of section 102 of the *Income Tax Assessment Act 1936*. In comparable circumstances a new trust estate will not arise under Division 6.

The situation is less clear when a later injection of assets takes place which is difficult to reconcile with the original trust purpose. One instance is the acquisition of new and different property in asset-specific trusts of the type referred to earlier. Another is when inactive trusts with negligible assets are 'revived' with new property. In these situations it may be that the injection amounts to a new trust estate incorporating the terms of the previous trust.

The ATO accepts that this will not always be the case. For instance, a general purpose trust vehicle controlled by a particular group or family may be dormant for a period and then reactivated for a new activity which, in the overall circumstances, would not amount to a new purpose or theme. On the other hand, when control and/or 'ownership' of a trust without significant assets passes to new parties who then establish a new trust fund, it may be that a new trust estate is created.

As a general principle, the ATO will usually not treat the *mere* addition of new property to an existing trust fund as giving rise to a new trust estate. However, such additions will be taken into account when accompanied by other potential indicia of a new trust.

An important point is that there can be no trust without trust property, so exhaustion of the trust fund will bring a trust estate to an end.

5.4. CHANGES OF TRUSTEE

A change of trustee does not in itself result in a termination of the trust. If there is merely a change of trustee, the trust property with the accompanying equitable duties are assumed by the new trustee and the trust estate continues unchanged. On the other hand, a change in the trustee or control of the trustee may be an element in arrangements which in their entirety amount to the creation of a new trust.

5.5. CHANGES TO THE TERMS OF THE TRUST

It is important to distinguish between changes which are merely procedural and those which fundamentally redefine the relationship between the trustee and beneficiaries in respect of the trust property. It is generally only changes of the latter type which will give rise to a new trust.

However:

- it is sometimes unclear whether a variation of terms is fundamental or merely procedural;
- extensive procedural changes may be taken into account along with other changes in considering whether there is a new trust; and
- in some circumstances new trusts have been held to arise even though their terms have been very similar to a prior arrangement (e.g. *Davidson v. Chirnside*).

The application of the general principle can be seen in the following examples.

<u>Conversion of a trust to a unit trust</u>

Example 5.5.1
The deed of a fixed trust is converted to substitute interests in the trust property for units and to allow the trustee to issue and redeem units.

In our view, the conversion of a non-unitised fixed trust to a unit trust may involve a fundamental change in the trust relationship. It may also be indicative of a new trust purpose, involving the creation of an actual or potential joint investment vehicle. The ATO would generally regard such a conversion as the creation of a new trust.

<u>Conversion of a fixed trust to a 'hybrid' discretionary trust</u>

Example 5.5.2
The deed of a fixed trust (unitised or otherwise) is amended to give the trustee a discretionary power of appointment over the income of the trust.

Although the new discretionary beneficiaries may not have a proprietary interest in the trust fund, the rights of the holders of previously fixed interests are radically changed. Previously, they would be presently entitled to, and accordingly had a right to demand, payment of all income. Now, assuming a mere power, any rights would only be in respect of the unappointed residue, if any. In this situation the essential nature and character of the trust relationship changes and a new trust estate comes into being.

Conferring a power to accumulate income

Example 5.5.3
A trustee is given the discretion to accumulate income to which beneficiaries previously would have been presently entitled.

The new discretion involves a material change in beneficiaries' rights. However, in the ATO's view this change will not usually be sufficient in itself to alter the essential nature and character of the trust relationship, and thus result in a new trust. Whether it does or not will depend on the essential nature of the change and its effects.

The ATO will accept that creating a power to accumulate is in itself consistent with a continuing trust where the retained income will accumulate solely for the benefit of those same beneficiaries who would have been presently entitled before the change.

Example 5.5.4
The beneficiaries of a unit trust are presently entitled to each year's income in proportion to their unit holdings. The deed is varied to give the trustee the discretion to accumulate some, or all, of the income. The beneficiaries' beneficial interests in the accumulated income are unaltered, and they are entitled to share in any distribution of income in proportion to their unit holdings.

Here, the accumulation power can be seen as enabling the trustee to decide from time to time whether the interests of the beneficiaries are best served by retaining or distributing income. Where any accumulations can only be for the benefit of those otherwise entitled to the income, the ATO accepts that conferring the power, in itself, alters the management of the trust's undertaking rather than the essential nature of the trust relationship itself. In the absence of other factors pointing to a new trust, the ATO accepts that no new trust estate arises.

Example 5.5.5
A discretionary trust deed ensures that beneficiaries are presently entitled to all income. It is varied to confer on the trustee a power to accumulate.

Provided that accumulations can only be appointed among the same class of beneficiaries as would otherwise have been presently entitled, the ATO view this situation in the same way as Example 5.5.4. In the absence of other factors, the variation goes to the management of the trust's undertaking rather than the essential nature of the trust relationship.

Example 5.5.6
A unit trust has X units with present entitlement to all income and Y units with rights to capital. The trustee is given a new discretion to accumulate income and add it to capital.

In contrast to the previous examples, here the effect of the change is to redefine the nature of the equitable interests in the trust fund. There is a fundamental change in the essential nature and character of the trust relationship, and this will bring about a new trust estate.

Definition of trust income

The insertion or variation of any 'income' definition in a trust deed potentially alters the substantive rights of beneficiaries. For example, if a deed defined 'income' as net income for the purposes of section 95 of the *Income Tax Assessment Act 1936* the respective rights of capital and income beneficiaries could be significantly different than if the term was undefined and ordinary trust law concepts applied. See, for example, the effect of the definition considered in *FCT v. Australian and New Zealand Savings Bank Limited* 98 ATC 4850.

Although inserting or varying an income definition may materially change the rights of beneficiaries, it may not in itself alter the essential nature and character of the trust relationship so as to result in a new trust estate. The ATO will accept that no new trust estate arises where, in the absence of other factors:

- it can be reasonably concluded that the purpose and effect of the new definition is to clarify rather than significantly redefine entitlements to income and capital; or
- where there is a significant change in respective entitlements, it is between the rights of a single beneficiary or class of beneficiary, rather than between different beneficiaries or classes of beneficiaries.

The second criterion reflects the principle which the ATO will apply to powers of accumulation. The changes under this heading are those which may affect a beneficiary's access to distributions at a particular time but not the essential nature of his/her interest in the trust.

Example 5.5.7
The property of a unit trust consists of an annuity with a substantial purchase price. The deed is amended to define 'income' as net income for the purposes of section 95 of the Income Tax Assessment Act 1936. There was no previous definition.

If the trust resembled Example 5.5.4, where income and capital rights accrue to the same units, the ATO would accept in the absence of other factors that there was no fundamental change in the trust relationship and no new trust estate. The change affects distribution of funds rather than the essential character of beneficiaries' interests. By contrast, if the trust resembled Example 5.5.6 the change would significantly alter entitlements between the two classes of units and be a strong indicator of a new trust relationship.

Given the uncertainty of the law and lack of clear judicial and ATO guidance in the past, the ATO will give less weight to changes or insertions of income definitions as indicia of a new trust when considering alterations made before the release of this statement. This will be so even if the effect of the change is such that it meets neither of the above criteria.

For instance, in response to the introduction of capital gains tax, deeds without an income definition may have been amended to define 'income' as tax law 'net income'. Where the variations took place before the release of this statement the ATO will not treat these changes as having in themselves terminated the previous trust. As with other factors which may not in themselves be determinative, they will be taken into account if accompanied by other features indicative of the creation of a new trust. For future arrangements, the principles outlined above will be applied.

Procedural changes

Changes which are merely procedural or administrative generally will not in themselves amount to the creation of a new trust. These could include:

- changes in the person acting as trustee or manager; or
- changes which merely affect administrative and 'housekeeping' procedures without substantially altering the rights of the beneficiaries in respect of the trust property.

It should be noted that changes may substantially alter beneficiaries' rights even though their interests are not adversely affected. What is important is the extent and nature of the change to the bundle of rights making up the beneficiaries' respective interests.

Once again, administrative and procedural changes will be taken into account when accompanied by other features pointing towards the creation of a new trust.

6. DATE OF EFFECT

These principles were originally released on 9 June 1999. This revised statement of principles reflects the High Court decision in *Commissioner of Taxation v. Commercial Nominees of Australia Limited* and the application of that decision. The ATO believes there has not been any change to the underlying principles as enunciated by the Commissioner on 9 June 1999.

These principles will be applied to arrangements implemented both before and after the date of their release. Nonetheless, the ATO recognise the uncertainty of the relevant law, the diversity of opinions held by experts, the past absence of ATO guidance and the serious consequences arising from the perhaps inadvertent termination of a trust estate.

For these reasons, the ATO will generally only treat arrangements already implemented as having resulted in a new trust estate where, in terms of the preceding principles, there are very strong indicia that the trust relationship has been fundamentally redefined.

Commissioner of Taxation
29 August 2001

APPENDIX TWO

<u>Cases Dealing with Settlements Generally</u>

In *Buzza v CS (Vic)* (1951) 83 CLR 286, Dixon J commented at 300 that:

"*It is notoriously difficult to define a settlement, but that does not mean that it is difficult to recognise one.*"

His Honour (at 300) expressly drew no distinction between a "*resettlement*" and a "*settlement*".

In *Buzza*'s case, Williams J at 310 said:

"*In* Commissioner of Stamp Duties (Q) v Hopkins *[(1945) 71 CLR 351 at 378) Dixon J said: <u>'An instrument is a settlement because it creates trusts and contains limitations which restrict or affect alienation and transmission, according to the course provided by law for estates in fee simple or a full ownership</u>.' In* Masserene v Commissioners of Inland Revenue *[(1900) 2 IR 138 at 146] Palles CB said, in a passage which exactly fits the present case: <u>'It is essential to such an instrument that there shall be - 1, such free property, by which I mean property which then is not, according to our jurisprudence, subject to the trusts in question; 2, a settlor, who either is, or appears on the face of this instrument to be, competent to subject that free property to trust which, until the execution of the instrument, do not bind it; and 3, an imposition by the instruments of such trusts upon such property</u>.'*" (underlining added)

The issue considered in *Davidson v Chirnside* (1908) 7 CLR 324 concerned the exercise by the trustees of a will of a power contained in the Will to resettle certain property on new trustees and on terms generally set out in the Will. The Court had to decide whether the deed "resettling" the estate property on the new trustees upon trusts corresponding with those previously declared in a Will was liable to stamp .duty as "an instrument of settlement". The High Court held that the deed was an instrument of settlement, but was not dutiable as it fell within the terms of an exemption in respect of the exercise of powers of appointment in circumstances where duty had already been paid on the property in respect of which the power of appointment was given.

Griffith CJ stated (at 341) that:

"... any instrument, which on its face purports to be the charter of future rights and obligations with respect to the property comprised in it, ...is a settlement or agreement to settle ...whether those rights could have been established aliunde or not. If a statement of already existing rights is added as a mere incident to the main operation of the instrument, as in the case of the appointment of a new trustee of an existing trust, this condition is not fulfilled, <u>for in such a case the charter would still be the original settlement</u>." (underlining added)

Along similar lines is the statement by Isaacs J (at 345) in relation to the instrument in question:

"On its face it does settle the property on trustees for the daughter and does so by the authority of the Will from which she primarily derives all her rights, it is now in effect the source of the powers and duties of the settlement trustees, and regulates henceforth the relations between them and their cestui que trust. The trusts of the will as such no longer applied to her or her legacy; and although the trusts, which do apply, correspond to the trusts of the will, they are not trusts of the will. The document is, therefore ...a separate and independent title deed which answers technically and substantially to the description of settlement as generally understood ...".

Previously, in *Davidson v Armytage* (1906) 4 CLR 205 the High Court considered certain deeds executed in accordance with a power of appointment contained in a settlement by which persons were appointed in fee after the expiration of life estates. The Court held that the interests created under the deeds were new interests in the property, and therefore effected a settlement of that property.

In *Davidson v Armytage* at 210-11, it is said:

"*In the case of* Wiseman v Collector of Imposts *[21 VLR 743 at 748], Madden CJ, speaking of the term 'settlement', said:- 'It must create a beneficial interest in some person in whom it did not previously exist.' That is, of course, not an exhaustive definition, but that condition is fulfilled in the present case, because although in default of these deeds of Appointment the same persons would have taken a share of property as tenants in common in fee, it is settled by* Sweetapple v Horlock *[11 Ch D 745], the authority of which has not been disputed, that the interest taken under the deeds are new interests.*" (underlining added)

In *Comptroller of Stamps (Victoria) v Howard-Smith* (1936) 54 CLR 614 the High Court held that a letter to a trustee directing it to distribute the writer's interest in an estate to named recipients was not dutiable as either a gift or the creation of a trust. Rather, it was merely a mandate authorising the trustee to deal with specified property in a specified manner. Of central importance was the writer's intention. Dixon J stated (at 620) that the letter would not be dutiable:

"... unless by the instrument itself equitable interests were made over to the various persons and bodies intended to benefit."

The High Court in *Wedge v The Acting Comptroller of Stamps (Victoria)* (1941) 64 CLR 75 considered the situation where all the beneficiaries of a deceased estate requested the trustee to transfer the trust property to the residuary beneficiary. The residuary beneficiary made an undertaking in writing to hold the trust property subject to the trusts of the will. The High Court held that the document of undertaking was not an instrument whereby property is settled or agreed to be settled on the basis that no new beneficial interests were created and that the property remained subject to the same trusts as it did before the instrument of undertaking was executed.

Williams J applied the dicta of Palles CB. in *Massereene v Commissioner of Inland Revenue* (1900) 2 IR 138 (at 146), referred to in an above quote, and noted at 82-83:

"*His undertaking was a mere recognition of existing trusts. The case is therefore distinguishable from that of* Davidson v Chirnside*. In that case the instrument, which was held liable to duty, contained such limitations as are ordinarily contained in settlements, was executed by a settlor, namely, the trustees of the will, and settled property, namely a sum of money which the trustees had been authorised by the testator to settle. As Griffith CJ pointed out (at 340), the rights conferred or declared by the settlement were, in a real and substantial sense, new rights. Isaacs J said that the new trusts, although they corresponded to the trusts of the Will, were not trusts of the Will (at 345).*" (underlining added)

Rich *ACJ* said at 79:

"The question must be determined by construing the particular instrument, which, of course, includes the transaction set forth in that instrument (Collector of Imposts (Vict.) v Peers (3)), and examining its legal effect. The subject instrument contains no disposition or agreement to dispose of property belonging to the appellant but is merely an acknowledgment or recognition that he is not the absolute owner of the property comprised in the instrument and preserves other trusts or rights affecting it. No new beneficial interest is created in favour of the appellant or anybody else, and the property remains subject to the same trusts as it did before the instrument was executed."

In *Hopkins* case, Rich J stated (at 367) that:

"In order that a document may constitute a settlement, it is essential (subject to any artificial meaning which may be attributed to that word by statute) that it should at least operate or contribute to cause property, in the sense of some right or interest of a proprietary nature, to become, either at law or in equity, vested in some person or devoted to some charitable purpose.' (underlining added)

The statements on settlements referred to above indicate that the concept of "settlement" involves the creation of new trusts, which may be demonstrated by the vesting of beneficial or proprietary interests in persons in whom such interests did not previously exist.

Other cases in which the issue has been discussed but assist no further in elucidating the concept of "*settlement*" are *Duke of Northumberland v IRC* [1911] 2 KB 343 and 1011; *Grollo v CS (Vic)* (1981) 12 ATR 615; *Scott v CS (Vic*) [1967] VR 122; *Micklewait v Micklewait* (1857) 140 ER 1302; *Affleck v Collector of Imposts* (1901) 7 ALR 237; *Re The Settlement of Austin* (1901) 27 VLR 408; *Newman v Collector of Imposts* (1903) 29 VLR 161; *CSD (Qld) v Chaille* (1924) 35 CLR 166*; Queensland Trustees v CSD (Qld)* [1938] St R Qd 208; *Re Gowan* (1880) 17 Ch D 778; and *Re Sharpe* [1945] St R Qd 1.

Cases Dealing with Variations to Instruments of Settlement before Buckle's case

Watchorn v Comptroller of Stamps 1969 VR 128 is authority for the proposition that an instrument which effects a material alteration to the provisions of an earlier instrument of settlement is, itself liable to stamp duty as a "settlement". Little J held in that case:

"' A material alteration is one which varies the rights, liabilities or legal position of the parties as ascertained by the deed in its original state or otherwise varies the legal effect of the instrument as originally expressed': see Halsbury, Laws of England, 3rd ed., vol. 11, p. 368, paras. 599 and 601, pp. 370, 371, para. 604."

In that case, His Honour held that a material alteration was effected by the Deed of Amendment. The reason for this finding however was that the amendment effected a change of beneficial ownership of the underlying assets resulting in the creation of new trusts. His Honour held as follows in that regard:

"By the 1965 deed, accordingly, the wide discretionary trust previously existing is entirely removed and in its place a mandatory obligation is imposed on the trustees, while the member remained in the service of the employers, to apply the money for the maintenance of the member and his dependants to the extent necessary to relieve hardship." (underlining added)

If it is correct to say that an instrument which effects a material alteration to the provisions of an earlier instrument of settlement is, itself a "settlement", then the case of *Watchorn* is authority for the proposition that a material alteration is one where as a consequence of the amendment the previously existing trust "is entirely removed" and is replaced by a new trust.

The test put forward in *Watchorn* as to whether an instrument of variation of an existing instrument of settlement is itself to be regarded as a settlement, is no different to the tests discussed above in the cases dealing with instruments of settlement generally. *Watchorn* is therefore a clear case of creation of new trusts demonstrated by the vesting of beneficial or proprietary interests in persons in whom such interests did not previously exist.

See also Hill J, “Stamp Duties, New South Wales and Australian Capital Territory” LBC (looseleaf) where His Honour notes at para 3.4430:

"…it is …essential that the settlement create beneficial interests in some person in whom such interests did not previously exist. See Davidson v Armytage, supra; Wedge v Acting Comptroller of Stamps (Vic) (1940) 64 CLR 75; Commissioner of Stamp Duties (Qld) v Hopkins (1945) 71 CLR 367, where Rich J said that it was essential that "it should at least operate or contribute to cause property, in the sense of some right or interest of a proprietary nature, to become, either at law or in equity, vested in some person or devoted to some charitable purpose"; and Tokenhouse Enterprises Pty Ltd v Commissioner of Stamp Duties (Qld) (1985) 16 ATR 967; 85 ATC 4682." (underlining added)

Hill J, at 3.4440 specifically notes that:

"Fundamental to the conclusion that an instrument is a settlement is a finding that the instrument subjects property theretofore free of the trusts to trusts enunciated in the instrument The reason that a variation of trusts will be a resettlement will be because the deed of variation will operate to impose new trusts upon property theretofore not subject to them." (underlining added)

The question to determine in each case therefore is whether the instrument of variation creates new trusts or only varies the terms of an existing trust.

A conclusion that new trusts are imposed upon property already the subject of other trusts:

- by an instrument of variation of the existing trust
- pursuant to power of amendment as a term of the existing trust,

involves of necessity a conclusion that the previous trusts to which the property was subject have determined ie the exercise of the power of variation is in substance an exercise of a power of extinguishment of the existing trusts and resettlement of the trust assets on new trusts. See Isaacs J in *Davidson v Chirnside* quoted above.

APPENDIX THREE

Extract from TIA background paper to the Assistant Treasurer

5. **Family Trust Elections** ("FTEs")

Issue

Many taxpayers since 1999 have failed to lodge family trust elections due in the main to a misconception that FTEs were only relevant in terms of the trust loss measures.

This misconception has a number of causes.

First, these rules took effect from 31 December 1997 even though the legislation (Act No 93 of 1999) did not receive Royal Assent until July 1999. This meant that the rules, in particular the transitional provisions relating to making FTEs in respect of earlier years, were swallowed up by the subsequent tax reform over the period, resulting in many taxpayers overlooking the change.

Compounding the problem was a lack of ATO information on the full implications of making FTEs. Materials on FTEs were only beginning to be released in late April 2003 and only in response to the NTLG raising this issue in December 2002.

This lack of ATO information combined with the prevailing 1998 wisdom (you only do a FTE where there is a loss) added further to the non-compliance.

Add to this:

- lack of clarity around the application of FTEs to imputation credits;
- confusion as to whether a family trust election has to be lodged with the ATO; and
- certain of the software packages widely used by tax agents over the relevant periods have not been able to deal with the making of a family trust election in an appropriate manner

and it is not surprising to find widespread non-compliance.

The problem is that taxpayers cannot remedy the situation, ffi the Commissioner currently has no express discretion to allow the making of a family trust election after the tax return for a year of income has been lodged.8

Furthermore the ATO has advised that an amended return including an FTE will not be accepted CB "lodging the election" for the specified year.

Impact

Many taxpayers, not being aware of the full range of implications of making or not making an FTE, particularly in regard to the so-called 45 day rule and the company loss tracing measures, have made distributions of franking credits or claimed losses. The resultant wide spread non-compliance combined with the absence of any remedial solutions is causing unnecessary concern amongst taxpayer seeking to comply with what are extremely complex laws.

Recommendations

At the last NTLG the Commissioner undertook to review whether he had any discretion to accept an election lodged where a taxpayer had acted as if an election had been lodged. However, as this involves a stretch of s 388-50 of the Taxation Administration Act 1953, The Taxation Institute is not hopeful of a favourable ruling.

Note that if no return is required to be lodged by the relevant entity .the FTE must be lodged no later than two months after the end of the tax year specified or such later day as the Commissioner allows.

In light of the circumstances set out above, the Taxation Institute is of the opinion that satisfactory resolution of this matter requires:

1. Extension of the previous transitional provisions relating to the introduction of the 45 day rule and the company loss tracing measures allowing additional time to lodge FTEs (and Interposed Entity Elections (IEEs) where relevant) in respect of previous years (back to the 1997 year) to the time of lodging the return for the 2003 income year. This would allow adequate time for taxpayers and their advisers to make an informed decision as to whether a FTE/IEE should be made. This should be accompanied by appropriate educational support from the ATO.

2. On a "go-forward" basis, granting the Commissioner discretion to allow lodgement of an FTE (and IEE where relevant) after the return has been lodged. This would be to cover situations such as where there are simple errors or omissions (in appropriate circumstances). An amendment to subsection 272-80(2) of Schedule 2F of the ITAA 1936 could be made to achieve this.

The Taxation Institute believes that such changes could be packaged as part of the pending amendments to the holding period and related payment rules required to take into account the new Simplified Imputation System (as announced by you on 27 September 2002 -Press Release C104/02) as consequential amendments to Schedule 2F of the Income Tax Assessment Act 1936.