

TD 2012/D4 - Income tax: does CGT event E1 or E2 in sections 104-55 or 104-60 of the Income Tax Assessment Act 1997 happen if, pursuant to a valid exercise of a power contained within the trust's constituent document, the terms of the trust are changed?

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Draft Taxation Determination

Income tax: does CGT event E1 or E2 in sections 104-55 or 104-60 of the *Income Tax Assessment Act 1997* happen if, pursuant to a valid exercise of a power contained within the trust's constituent document, the terms of the trust are changed?

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Ruling

1. No. Unless the amendment causes the trust to terminate for trust law purposes, or the effect of the amendment is to lead to a particular asset being subject to a separate charter of rights and obligations such as to give rise to the conclusion that that asset has been settled on terms of a different trust, neither CGT event E1 nor CGT event E2 in sections 104-55 or 104-60 of the *Income Tax Assessment Act 1997* (ITAA 1997) happens.

Example 1: addition of new entities to class of objects

2. The Acorn Trust is a family discretionary trust that was settled to benefit the members of the Squirrel Family. Under the terms of the trust deed the trustee, a private company of which Mr and Mrs Squirrel are directors, has the power at its absolute discretion to appoint income to any one or more of the General Beneficiaries defined to include Mr Squirrel, his wife, their children, their grandchildren, and entities associated with the family. The trust deed for the Acorn Trust provides for a procedure for the trust to be amended, namely by trustee resolution recorded in writing. Pursuant to this procedure the trustee resolves in writing to amend the deed to add to the class of General Beneficiaries the respective spouses of the children. The making of the resolution, being a valid exercise of a power of amendment contained within the deed, does not give rise to the happening of a CGT event.

Example 2: expansion of power to invest

3. The Hedgehog Investment Trust is a unit trust the unitholders in which are a group of five persons who have pooled moneys in order to invest in the stockmarket. Under the trust deed the trustee of the trust has the power to invest in listed securities. Included in the deed is a provision which permits amendment of the deed with the consent of all of the unitholders. Following a meeting of the unitholders at which they unanimously agree that the range of assets in which the trust invests should be expanded to include real property, the trustee resolves to amend the deed to correspondingly expand the class of assets in which the trustee is empowered to invest. The making of the resolution, being a valid exercise of a power of amendment contained within the deed, does not give rise to the happening of a CGT event.

Example 3: addition of definition of income and power to stream

4. The Lime Trust is a discretionary trust settled to benefit the members of the Linden family. The trust deed contains no definition of income nor does the deed contain a provision permitting the trustee of the trust to stream income.

5. Pursuant to an unfettered power of amendment in the deed the trustee resolves in writing to amend the deed to insert two clauses:

- the first defining the income of the trust to equal the net income of the trust as calculated under section 95 of the Income Tax Assessment Act 1936 (ITAA 1936), excluding franking credits, unless the trustee otherwise determines; and
- the second authorising the trustee to separately identify and label various sources of income or receipts that form part of the income of the trust estate and to deal with those amounts by reference to their labelling (that is, to 'stream' particular sources of income to particular beneficiaries).

6. The making of the resolution, being a valid exercise of a power of amendment contained within the deed, does not give rise to the happening of a CGT event.

Example 4: settling of trust asset on new trust

7. Under the provisions of the *Hedgerow Trust*, a discretionary trust the class of objects of which consists of a large number of entities, the trustee has a wide range of powers including the power to declare that particular assets of the trust are to be held exclusively for one of the trust objects to the exclusion of the other objects. In exercise of this power the trustee amends the deed with the effect of the amendment being that the trustee commences to hold one of several assets forming part of the corpus of the trust (subject to the trustee's other powers, such as its power of sale) exclusively in trust for Mr Badger, one of the objects of the trust. Whilst the amendment does not terminate the *Hedgerow Trust*, the effect of the amendment is to vary the trust obligations in respect of the asset concerned so as to cause the asset to be held on the terms of a new trust for the benefit of Mr Badger as sole beneficiary. As a result, CGT event E1 happens.

Date of effect

8. Subject to the exception mentioned in paragraph 9 of this draft Determination, when the final Determination is issued, it is proposed to apply both before and after its date of issue. However, the Determination will not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Determination (see paragraph 75 to 77 of Taxation Ruling TR 2006/10).

9. In any case where the views expressed in this draft Determination are less favourable to a taxpayer than the Commissioner's previous practice set out in *Creation of a new trust – Statement of Principles*, it does not apply in respect of changes to the terms of a trust pursuant to a valid exercise of a power contained within the trust's constituent document made before 20 April 2012.

Commissioner of Taxation13 June 2012

Appendix 1 – Explanation

❶ *This Appendix is provided as information to help you understand how the Commissioner's preliminary view has been reached. It does not form part of the proposed binding public ruling.*

10. CGT event E1 happens if a trust is created over a CGT asset by declaration or settlement (subsection 104-55(1)). One question that has arisen concerning the scope of this event is whether an existing trust can change in such a fundamental way that although the trust has not terminated for trust law purposes, nonetheless for tax purposes a new trust has come into being.

The Statement of Principles regarding so-called resettlements

11. In June 1999 in response to the Full Federal Court's decision in *Federal Commissioner of Taxation v. Commercial Nominees of Australia Ltd* [1999] FCA 1455; 99 ATC 5115; (1999) 43 ATR 42 (*Commercial Nominees*) the Commissioner published a 'Statement of Principles' to guide taxpayers, advisers and ATO decision makers on when the Commissioner would treat changes to a trust as giving rise to a new trust estate for income tax purposes.¹ The basic proposition underlying that Statement was that a new trust arises for these purposes where there was a 'fundamental change' to the trust relationship and that a change in the 'essential nature and character' of the trust relationship can result in the creation of a new trust.

12. The question of whether a trust has sufficiently changed such that it might be concluded that there is not sufficient continuity between the trust as originally constituted and the trust in its current form is relevant in a number of taxation contexts. The Statement of Principles was largely concerned with stating principles that would provide practical guidance to determining whether changes of a sufficient nature had occurred to a trust such as to enable it to be concluded that a new trust had come into existence for the purposes of the capital gain tax provisions. However, similar questions can arise in other areas. For example, a question may arise as to whether a trust estate has so changed such that any carried forward losses of a prior year are no longer available to be recouped against future income by reason of that future income being income of a different trust estate for income tax purposes.

The decision in Clark means the approach formerly set out in the Statement of Principles is not sustainable

13. On 21 January 2011, the Full Federal Court (Edmonds and Gordon JJ, Dowsett J dissenting) handed down its judgment in *Commissioner of Taxation v. David Clark*; *Commissioner of Taxation v. Helen Clark* [2011] FCAFC 5; 2011 ATC 20-236; (2011) 79 ATR 550 (*Clark*). That case raised squarely for consideration the circumstances in which it may be concluded that the nature of a trust has so changed that it might be concluded that the trust that originally incurred capital losses is not the same trust for income tax purposes as that which has derived gains against which the losses are sought to be recouped.

¹ Following an unfavourable appeal to the High Court, the Commissioner published a revision of the Statement in August 2001 largely in the same terms as the original Statement.

14. *Clark* was decided adversely to the Commissioner. Special leave sought by the Commissioner to appeal the decision to the High Court was rejected on 2 September 2011.

15. The Commissioner has explained his view on the administrative impact of the Court's decision in the following terms:²

The Commissioner considers that the decision of the Full Federal Court in *Clark* does not change the basic proposition that, based on the authority in *Commercial Nominees*, the relevant focus is on whether continuity of the trust estate has been maintained. That this is so is confirmed by the High Court's language in disposing of the Commissioner's application for special leave where the High Court noted that the decision of the Full Federal Court involved 'characterisation and evaluation of the **continuity of the trust estate**'.

The statute does not contain a statement of the applicable criteria against which continuity is to be assessed. As was recognised by the Full Federal Court in *Commercial Nominees* [at para 49], the consequence is that criteria must be established for these purposes. As decided by the High Court in *Commercial Nominees*, the Commissioner considers that the test to be applied looks to whether changes to one or more of the trust's constituent documents, the trust property, and the identity of those with a beneficial interest in the trust property are such as to terminate the existence of the trust.

To the extent that the High Court in *Commercial Nominees* left open the possibility that there might be a loss of continuity in circumstances short of the existence of the trust having come to an end, the Commissioner acknowledges that in *Clark* there were significant changes to the property, membership and operation of the [the relevant trust in that case] without any finding by the courts that there was a loss of continuity such as to deny the trust access to the losses being carried forward. Relevantly, in disposing of the Commissioner's special leave application, the High Court noted that the application raised the question:

[w]hether a trustee of a unit trust could set-off, against capital gains, capital losses incurred some years before under a different trustee with different unit holders, with an intervening excess of liabilities over assets, subsequent recapitalisation of the trust and a waiver by the original trustee of its right to be indemnified from the assets of the trust.

Accordingly, following *Clark*, there will not be a loss of continuity sufficient to deny a trustee access to any capital losses being carried forward without a termination of the existence of the trust estate.

16. It is clear following *Clark* that, at least in the context of recoupment of losses, continuity of a trust estate will be maintained so long as the trust is not terminated for trust law purposes. As such, in the absence of termination, tax losses being carried forward by a trustee will as a general rule remain available to be recouped against relevant trust income derived in future years of income.

² See the Commissioner's Decision Impact Statement in respect of *Clark*.

17. Furthermore, as a general proposition, it would seem that the approach adopted by the Full Federal Court in *Commercial Nominees*, as explained by Edmonds and Gordon JJ in *Clark*,³ is authority for the proposition that assuming there is some continuity of property and membership of the trust, an amendment to the trust that is made in proper exercise of a power of amendment contained under the deed will not have the result of terminating the trust, irrespective of the extent of the amendments so made so long as the amendments are properly supported by the power. Relevantly, in *Commercial Nominees* the Full Federal Court had stated that

55. ...in order to determine whether losses of particular trust property are allowable as a deduction from income accruing to that trust property in a subsequent income year, **it will be necessary to establish some degree of continuity of the trust property or corpus** that earns the income from the income year of loss to the year of income. **It will also be necessary to establish continuity of the regime of trust obligations affecting the property in the sense that, while amendment of those obligations might occur, any amendment must be in accordance with the terms of the original trust.**

56. **So long as any amendment of the trust obligations relating to such trust property is made in accordance with any power conferred by the instrument creating the obligations, and continuity of the property that is the subject of trust obligation is established**, there will be identity of the “taxpayer” for the purposes of section 278 and sections 79E(3) and 80(2), notwithstanding any amendment of the trust obligation and any change in the property itself.

18. The Commissioner had been of the view that the High Court in *Federal Commissioner of Taxation v. Commercial Nominees of Australia Ltd* [2001] HCA 33; 2001 ATC 4336; (2001) 47 ATR 220 had advanced what on its face appeared to be a different test. That is, in the Commissioner’s view, the High Court had seemed not only to focus on whether the trust had come to an end, but had also envisaged that changes to one or more of the property, membership and operation of a trust might be sufficient to result in a loss of continuity even if the trust had not terminated. However in light of Federal Court’s decision in *Clark*, and the High Court’s disposal of the Commissioner’s special leave application, the Commissioner accepts as an accurate statement of the current law that continuity of trust is a function of whether the trust continues in existence under trust law in contradistinction to having terminated.

19. As so understood, the comments made by the Federal Court in *Commercial Nominees* relating to amendments to trust obligations represents good law.

Effect of a valid amendment of a deed

20. Even though *Clark* and *Commercial Nominees* were decided in the context of whether changes in a continuing trust were sufficient to treat that trust as a different taxpayer for the purpose of applying relevant losses, the ATO accepts the principles set out in these cases have broader application. Relevantly, the principles established by those cases are also relevant to the question of the circumstances in which CGT event E1 may happen as a result of changes being made to an existing trust. In light of those principles, the ATO accepts that a valid amendment to a trust pursuant to an existing power will not result in termination of the trust and, therefore, subject to the observation in paragraph 23 below, will not result in CGT event E1 happening.⁴

³ See at paragraph [78] and [79].

⁴ Where an asset is instead transferred to an existing trust, CGT event E2 will be the relevant event (subsection 104-60(1)).

21. On this basis the 'Creation of a new trust – Statement of Principles August 2001' was withdrawn on 20 April 2012.
22. Whether a purported amendment is properly supported by a power in the deed is to be determined in accordance with principles of trust law having regard to the scope of the power properly construed. Relevant to this question will be whether the deed itself explicitly specifies conditions (including procedural conditions) that need to be satisfied for an amendment to be effective.
23. Even in instances where a pre-existing trust does not terminate, it may be the case that assets held originally as part of the trust property commence to be held under a separate charter of obligations as a result of a amendment to the deed such as to lead to the conclusion that those assets are now held on terms of a distinct trust.
24. In *Commissioner of State Revenue v. Lam & Kym Pty Ltd* [2004] VSCA 204; 2004 ATC 5058; (2004) 58 ATR 60 the Supreme Court of Victoria considered a scenario in which by deed of settlement a trustee stood possessed of a fund on discretionary trust for two classes of objects (the Primary Beneficiaries and the Discretionary Beneficiaries). By deed poll the trust was amended giving the trustee the power to transfer the whole or any portion of the fund to or for the advancement of any of the Discretionary Beneficiaries. The trustee subsequently executed an instrument in which it declared that it 'hereafter held separately in trust' particular real estate for certain beneficiaries. Nettle JA (with whom Vincent JA and Hansen AJA agreed) held that the exercise of the power of appointment had the result of the real estate being held on separate trust.
25. Analogously, depending on the facts, the effect of the amendment might be such as to lead to the conclusion that a particular asset has been settled on terms of a different trust by reason of being made subject to a charter of rights and obligations separate from those pertaining to the remaining assets of the trust.

Appendix 3 – Your comments

26. You are invited to comment on this draft. Please forward your comments to the contact officer by the due date.

27. A compendium of comments is prepared for the consideration of the relevant Rulings Panel or relevant tax officers. An edited version (names and identifying information removed) of the compendium of comments will also be prepared to:

- provide responses to persons providing comments; and
- be published on the ATO website at www.ato.gov.au

Please advise if you do not want your comments included in the edited version of the compendium.

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References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 2006/10

Subject references:

- amendment of trust deeds
- creation of new trust
- resettlement of trust
- trust deeds
- trusts

Legislative references:

- ITAA 1936 95
- ITAA 1997 104-55(1)
- ITAA 1997 104-60(1)

Case references:

- Commissioner of State Revenue v. Lam & Kym Pty Ltd [2004] VSCA 204; 2004 ATC 5058; (2004) 58 ATR 60

- Commissioner of Taxation v. David Clark; Commissioner of Taxation v. Helen Clark [2011] FCAFC 5; 2011 ATC 20-236; (2011) 79 ATR 550
- Federal Commissioner of Taxation v. Commercial Nominees of Australia Ltd [1999] FCA 1455; 99 ATC 5115; (1999) 43 ATR 42
- Federal Commissioner of Taxation v. Commercial Nominees of Australia Ltd [2001] HCA 33; 2001 ATC 4336; (2001) 47 ATR 220

Other references:

- 'Creation of a new trust – Statement of principles' published June 1999 (revised August 2001, and withdrawn 20 April 2012)
- Decision Impact Statement on Commissioner of Taxation v. David Clark; Commissioner of Taxation v. Helen Clark [2011] FCAFC 5 - DIS QUD 1 of 2010

ATO references

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