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CGT problems in Trust Transactions

Television Education Network

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Table of contents

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1 Introduction

1.1 Trusts are a fundamental aspect of tax-effective business structuring in the SME market.

1.2 This paper considers the following two aspects of trust taxation:

(a) Part 1 - the ability to stream trust capital gains and the associated capital gains tax (**CGT**) consequences to intended beneficiaries; and

(b) Part 2 - the CGT consequences when restructuring and winding up a trust.

Part 1 – streaming capital gains

2 A bit of history and where we are at - *Bamford*

2.1 The trust streaming provisions in Subdivisions 115-C and 207-B *Income Tax Assessment Act 1997* (**Tax Act 97**) are the current provisions which regulate the trust streaming of capital gains and franked dividends. Before reviewing the streaming of trust capital gains under Subdivision 115-C ITAA 97, it is worth refreshing on how we got to where we are.

2.2 The genesis of the current trust streaming provisions is the landmark High Court case of *Bamford*[1] which established that:

(a) the phrase 'income of the trust estate' in section 97 *Income Tax Assessment Act 1936* (**Tax Act 1936**) means trust income as determined in accordance with trust law principles (hereinafter referred as **Trust Income**); and

(b) the 'share' of 'net income of the trust estate' (being the taxable income derived by the trust and hereinafter referred to as **Net Tax Income**) assessed to a beneficiary under section 97 Tax Act 1936 is the beneficiary's proportionate share of Trust Income, rather than any approach based on the quantum of Trust Income received by the beneficiary.

2.3 Briefly, the facts in *Bamford* involved the taxation of Net Tax Income of a trust in two income years:

(a) in the 2000 income year the trustee resolved to distribute $34,000 each to Mrs and Mrs Bamford with the balance of Trust Income to the Church of Scientology. Subsequently it was discovered that certain deductions claimed by the trust were not allowable under the tax law. This caused the Net Tax Income of the trust to exceed its Trust Income and the issue was how this excess should be taxed under section 97 Tax Act 1936. Mr and Mrs Bamford sought to argue that they should be taxed only on the amount of Trust Income actually distributed to them. This contrasted with the Commissioner of Taxation's (**Commissioner**) approach which was to include in Mr and Mrs Bamford's assessable income, the proportion of Net Tax Income derived by the trust which was referable to the proportion in which Trust Income had been distributed Mr and Mrs Bamford;

[1] *Commissioner of Taxation v Phillip Bamford & Ors* [2010] HCA 10

(b) in the 2002 income year the only taxable income derived by the trust was a net capital gain. Apart from the net capital gain, the trust derived no other Trust Income. The trust deed for the trust did not define Trust Income but included a provision which allowed the trustee to include a capital gain in Trust Income. The trustee exercised this power and resolved to distribute the net capital gain to beneficiaries. The Commissioner sought to argue that that the concept of Trust Income was fixed to ordinary concepts and could not include a capital gain. Consequently the Commissioner sought to assess the trustee on the capital gain at the top marginal tax rate under section 99A Tax Act 1936.

2.4 With respect to the 2000 income year, the High Court clarified that the proportionate approach adopted by the Commissioner was the correct approach to adopt in determining a beneficiary's share of Net Tax Income of a trust. In determining this issue, the High Court ended a long running debate as to whether a proportionate or quantum approach to determining a beneficiary's share of Net Tax Income was correct.[2]

2.5 In relation to the 2002 income year, the High Court determined that the concept of Trust Income takes its meaning from trust law. Trust Income was therefore determined in accordance with the terms of the trust deed, general trust law and appropriate accounting principles. As a result the High Court ruled that the Commissioner was wrong to tax the capital gain made by the trust in the 2002 income year under section 99A Tax Act 1936. Since the trust deed conferred on the trustee the power to include a capital gain in Trust Income and this had been validly exercised by the trustee, the High Court ruled that the net capital gain should be assessed to the beneficiaries to whom distributions of Trust Income had been made.

2.6 The ATO's views on *Bamford* are summarised in its Decision Impact Statement as follows:

(a) the concepts of Trust Income and Net Tax Income are two different subject matters which do not necessarily correspond.

(b) in subsection 97(1) of the Tax Act 1936, 'income of the trust estate' (i.e. Trust Income) takes its meaning from the general law of trusts and not from taxation law;

(c) under the general law of trusts the concept of 'income' is governed by a set of rules designed to ensure that trustees fairly apportion the receipts and outgoings of a period between those entitled to income and those with an interest in capital;

(d) under trust law, there are presumptions about whether particular receipts or outgoings constitute income or capital of the trust but these presumptions can be displaced by express provision in the trust deed;

(e) the 'proportionate approach' applies in determining a beneficiary's share of the trust's Net Tax Income; and

(f) the proportionate approach is a mathematical calculation based on applying the percentage share that a beneficiary is presently entitled to Trust Income, to the trust's Net Tax Income.

Bamford's effect on the definition of Trust Income in trust deeds

2.7 The High Court's ruling in *Bamford* that Trust Income could be modified by express provisions in a trust deed caused many trustees to review and vary their trust deed to ensure that they had the necessary powers to defined Trust Income to administer their trust in a tax effective manner. Significantly, trustees were concerned to ensure that they had powers to define Trust Income so that they would not be left in a situation where there was no Trust Income, such that any Net

[2] See *Davis v FCT* 89 ATC 4377.

Tax Income would be taxed under section 99A Tax Act 1936. In particular *Bamford* indicated that capital gains (which are income according to ordinary concepts) could be included Trust Income where the trustee had an express power to do so.

2.8 Since *Bamford* an appropriately trust deed should ideally confer on the trustee all the following powers:

(a) a discretion to define Trust Income (such that Trust Income may deviate from income according to ordinary concepts);

(b) a power to characterise receipts and outgoings as either constituting income or capital receipts (this includes a power to reclassify capital gains as income);

(c) a power to account for and separately apply different categories or classes of income for the benefit of beneficiaries (i.e. a trust streaming power); and

(d) a power to determine whether or not to offset prior year trust losses against current year income.

2.9 The reasoning for including the last power concerning trust losses is to provide the trustee with the power to displace the traditional rule in *Upton v Brown* (1879) 12 Ch D 872 that prior year losses must be recouped against current year Trust Income.[3] This power can be useful where there is a disparity between trust losses and tax losses – for instance, a trust fails the trust loss tests and so cannot claim the benefit of prior year losses. If the rule in *Upton v Brown* is not displaced in this situation, it is possible to have a section 99A situation where trust losses reduce Trust Income to nil but there is still positive Net Taxable Income for the trust.

2.10 Since *Bamford* the Commissioner has sought to try to place limits on the extent to which trustees can define Trust Income – his overriding concern being that tax will be avoided where trustees recharacterise amounts which are truly income into capital (for tax-free distribution to trust principals) and distribute the bulk of Trust Income to a tax exempt (or low tax rate) beneficiary to be taxed on the lion's share of the trust's Net Tax Income. As a response to *Bamford* the Commissioner issued Draft Taxation Ruling TR 2012/D1 where he has sought to define Trust Income. In the Commissioner's view 'income from the trust estate' (i.e. Trust Income) must be:

(a) measured in respect of distinct income years (being the same years in respect of which the trust's Net Tax Income is calculated);

(b) a product of the trust estate – since 'income' and 'trust estate' are distinct concepts, it follows that something which formed part of the trust estate at the start of an income year cannot be treated by the trustee as income of the trust for that year; and

(c) an amount in respect of which a beneficiary can be made presently entitled – i.e. it cannot include notional amounts such as the franking credit gross up, amounts included in assessable under the accrual provisions of transferor trust rules and controlled foreign companies rules, and deemed capital gains arising from the application of the deemed market value capital proceeds rule.

[3] Note that the High Court in *Raftland Pty Ltd as trustee of the Raftland Trust v FCT* 2008 ATC 20-029 has ruled that the rule in *Upton v Brown* does not always operate in situations where beneficiaries have co-extensive rights (e.g. a unit trust where there is one class of units), and in such a situation a trustee may choose not to recoup current income against prior year losses. In the case of a typical family trust where there may be different income and capital beneficiaries, it is recommended that the trustee should be conferred a specific power to choose whether to offset current income against prior year losses since these beneficiaries' rights are not co-extensive.

2.11 In the Commissioner's opinion this means that notwithstanding how a particular trust deed defines trust income, the Trust Income must represent the net accretion to the trust estate for the relevant period. In other words the Trust Income for an income year cannot be more than the sum of:

(a) the accretions to the trust estate (whether accretions of property or increase in value) for that year;

(b) less any accretions to the trust estate for that year which, pursuant to general trust law (as may be affected by the trust deed), have not been allocated to income (and as such cannot be distributed as income); and

(c) less any depletions to the trust estate for that year, which pursuant to general trust law (as may be affected by the trust deed) have been charged against income.

2.12 The Commissioner's suggestion that Trust Income must represent a net accretion is controversial because it contradicts the reasoning in *Bamford* and the Full Federal Court decision of *Cajkusic v FCT* 2006 ATC 4752, which indicates that provisions of a trust deed can determine Trust Income. TR 2012/D1 has not yet been finalised and it is not clear whether the ATO will finalise it in its current form due to this controversial point.

2.13 The upshot of the Commissioner's drafting ruling and *Bamford* is that most trust deeds now either:

(a) adopt a definition of Trust Income which approximates net income as defined in section 95 Tax Act 1936 less notional amounts; or

(b) provide the trustee with extensive powers to determine Trust Income so that the difference between Trust Income and Net Taxable Income is reduced.

2.14 Arguably, the Commissioner's concern about taxpayers using trustee powers to avoid tax by recharacterising income amounts is misplaced since case law indicates that there are limits to the extent that a trustee can define Trust Income and in any event, a blatant recharacterisation of income to capital is likely to fall foul of the general anti-avoidance provisions of Part IVA Tax Act 1936. In *Forrest v FCT* 2010 ATC 20-163 the Full Federal Court ruled that a trustee could not exercise a broad power to recharacterise receipts and outgoings as income or capital without regard to the terms of the trust. In that case the trust was a hybrid trust with unitholders holding a fixed entitlement to trust income and discretionary beneficiaries who were potentially entitled to distributions of capital gain. The issue in that case was whether the taxpayer (as an income unitholder) could deduct interest expenses incurred on a borrowing taken out to subscribe for their income units in the hybrid trust. The Administrative Appeals Tribunal (**AAT**) had denied the interest deduction on the basis that the trustee's power to recharacterise receipts and outgoings prevented the taxpayer from being presented entitled to Trust Income. The Full Federal Court allowed the taxpayer's appeal against this AAT ruling, holding that despite the fact the trustee was given a trust power which literally allowed the trustee to recharacterise any amount as income or capital, it did not mean that the trustee could actually do that. Rather the trustee was under an obligation to exercise that power within the terms of the trust, and in light of this the trustee could not exercise the recharacterisation power in a way which would deprive income unitholders their entitlement to Trust Income.

Bamford's effect on trust streaming

2.15 The Commissioner's strict reading of the proportionate approach endorsed by *Bamford* – i.e. that it is strict mathematical approach based on applying the percentage of Trust Income a beneficiary is presently entitled to, to Net Taxable Income, raised issues as to whether trust streaming was possible. That is, whether income retains its character passing through a trust and whether a trustee could resolve to distribute different types of trust income to different beneficiaries. Prior to *Bamford* it had been an article of faith that it was possible for a trustee to distribute different types of trust income to different beneficiaries provided that there was an adequate trust streaming provision in the trust deed.[4] The Commissioner's reading of the proportionate approach meant that no trust streaming could be done because taken to its theoretical limit, the proportionate approach meant that a beneficiary received a proportion of each and every type of trust income derived by the trust. It is not possible to differentially distribute franked dividends to one beneficiary and capital gains to another beneficiary under the proportionate approach. Rather both of the beneficiaries would be considered to have received a proportion of the franked dividends and a proportion of the capital gains.

2.16 The position taken by the Commissioner was considered controversial because it upset established practice that streaming was possible and it seemed to conflict with the way that the imputation provisions and withholding tax provisions operates – those provisions implicitly relied on trust streaming. To resolve the uncertainty concerning whether trust streaming was possible the Government enacted trust streaming provisions in Taxation Laws Amendment (2011 Measures No.5) Act 2011 (**TLAM5**) with effect for the 2011 and future income years. The - TLAM5 measures were intended as 'interim' measures until a rewrite of the trust taxation rules was undertaken. However, as the years have rolled on without clear guidance from the Government when this rewrite will occur it seems that the TLAM5 amendments will be with us for some time.

2.17 A summary of key points arising out of the TLAM5 amendments are as follows:

(a) All capital gains and franked distributions are now assessed to a beneficiary under Subdivision 115-C and Subdivision 207-B *Income Tax Assessment Act 1997* (**Tax Act 1997**) – this is regardless of whether there is streaming of these types of income. Subdivision 115-C allows for streaming of capital gains and Subdivision 207-B allows for streaming of franked dividends.

(b) The TLAM5 streaming amendments do not deal with whether a trustee can stream other classes of income other than franked distributions and capital gains. For instance, they do not allow a trustee to specifically stream interest income to a non-resident to take advantage of the lower 10% interest withholding tax rate. Subsequent to the enactment of the TLAM5 amendments, the Full Federal Court in *FCT v Greenhatch* [2012] FCAFC 84 endorsed the Commissioner's mathematical approach to applying the proportionate approach. This suggests that outside of the TLAM5 streaming amendments it is not possible to stream other types of trust income differentially as between beneficiaries.

On 9 April 2015 the Government released exposure draft legislation for managed investment trusts (**MITs**) which include provisions which will allow certain types of trust income to retain their character passing through the MIT to a beneficiary. The start date for this new MIT regime has been deferred until 1 July 2016 and to date no legislative bill to enact these proposed amendments into law, has been issued. This MIT exception, however, does not apply to the types of trusts used by the SME market, who will need to comply with the TLAM5 streaming amendments and the ruling in *Greenhatch*.

The fact that the withholding tax provisions implicitly rely on income retaining its character passing through a trust, was not dealt with by the TLAM5 amendments, and how those provisions sit with the mathematical approach of the proportionate method has been left to be resolved for another day.

(c) If a trustee wishes to stream capital gains or franked distributions to specific beneficiaries, the process under the TLAM5 amendments is:

[4] The leading case relied upon being *Charles v FCT* (1954) 90 CLR 598.

(i) Start with Division 6 Tax Act 1936 – determine each beneficiary's share of the '*income of the trust estate';*

(ii) Determine amounts of capital gains and franked distributions to which beneficiaries are **specifically entitled** – **see below how a specific entitlement arises** - and each beneficiary's *'adjusted Division 6 percentage'* of the **remaining** '*income of the trust estate';*

(iii) Apply the Subdivisions 115-C and 207-B Tax Act 1997 to assess the beneficiaries (or trustee) on their share of capital gain made or franked distributions derived by the trustee; and

(iv) Apply Division 6E Tax Act 1936 to adjust the taxable income amounts otherwise assessed to a beneficiary (or trustee) under Division 6 Tax Act 1936.

(d) Capital gain and franked distributions to which no beneficiary is specifically entitled to will be allocated proportionately to beneficiaries using the adjusted Division 6 percentage - being their present entitlement to *'income of the trust estate'* excluding capital gains and franked distributions which any entity is specifically entitled to.

(e) The balance of the *'income of the trust estate'* (after deducting **all** capital gains and franked distributions), appointed to beneficiaries is assessed under Division 6 but using the adjusted Division 6 percentage. Double taxation is avoided by Division 6E Tax Act 1936 eliminating capital gains and franked distributions from Division 6 Tax Act 1936.

2.18 The effect of the TLAM5 amendments is that where a trust derives a capital gain, a trustee has a choice:

(a) make a beneficiary specifically entitled to the capital gain (i.e. stream the capital gain to that beneficiary), such that that beneficiary is liable for the tax consequences flowing from the capital gain; or

(b) make no beneficiary specifically entitled to the capital gain, in which case the TLAM5 amendments operate to enforce the mathematical *Bamford* proportionate approach such that beneficiaries who are presently entitled to Trust Income will be assessed on the capital gain according to their proportional present entitlement.

2.19 Given the presence of the 50% CGT discount and the need to have a significant individual to claim certain small business CGT concessions (e.g. the retirement exemption), trustees are generally motivated to ensure that the right beneficiary is made specifically entitled to a trust capital gain. For instance, since the benefit of the 50% CGT discount is clawed back if the capital gain is distributed to a company, a trustee would ensure that individuals are specifically entitled to the capital gain.

3 How do we make the beneficiaries specifically entitled to the capital gains?

3.1 Section 115-228 Tax 1997 provides that a beneficiary is specifically entitled to a capital gain in the proportion that that beneficiary shares in the total 'net financial benefit' of the capital gain.

3.2 A **beneficiary's share of net financial benefit** is the amount equal to the part of the financial benefit that, **in accordance with the terms of the trust**:

(a) the beneficiary **has received, or can be reasonably expected to receive**;

(b) **is referable to the capital gain** – after reduction by capital losses which are applied consistently with the application of the capital losses against the capital gain in the net capital gain method statement under section 102-5(1) Tax Act 1997; and

(c) is **recorded, in its character** as referable to the capital gain, in the accounts or records of the trust no later than two months after the end of the relevant income year.

3.3 The concept of a 'specific entitlement' differs from the concept of a 'present entitlement' to Trust Income. The latter concept relates to a beneficiary's present right to demand payment from the trustee according to the beneficiary's rights under the trust deed and trust law. The concept of specific entitlement is in some ways much easier to meet than the concept of present entitlement and in other ways is more stringent than the present entitlement concept since it looks in substance at the financial benefit a beneficiary will reasonably receive. This can be seen in the following discussion.

Making a beneficiary specifically entitled under the terms of the trust

3.4 The Explanatory Memorandum (**EM**) to TLAM5 indicates a specific entitlement can be recorded in the accounts or records of the trust which include the trust deed itself, statements of resolution or distribution statements including schedules or notes which are attached or intended to be read with such statements. A record which is merely for tax purposes (e.g. a beneficiary distribution statement in a tax return) would not be enough to create a present entitlement. This because section 115-228 Tax Act 1997 speaks of a specific entitlement 'in accordance with the terms of the trust'.

3.5 Practically speaking this means that a beneficiary would be specifically entitled to a capital gain either:

(a) directly via the terms of the trust deed (e.g. the provisions of the trust deed state that the beneficiary is entitled to all capital gains derived by the trust. Unitholders in a fixed trust would be specifically entitled to capital gains derived by the trust in accordance with their proportionate unitholding); or

(b) as a result of the trustee exercising its income and/or capital powers to resolve to make the beneficiary specifically entitled to the capital gain. This would be the most common method of making a beneficiary specifically entitled to a capital gain.

3.6 Where a trustee wishes to make a resolution to make a beneficiary specifically entitled, it is necessary to have regard to fact that:

(a) the trust resolution creating the specific entitlement must specifically refer to the **gross capital gain** derived by the trust – a trust resolution which provides that a beneficiary is entitled to 'the balance of trust income', 'all of the trust income', 'half of the trust income' or '$100 of trust income' would not be enough to create to create a specific entitlement;[5]

(b) it is not necessary to outline a particular amount of a capital gain, and it possible to express the specific entitlement based on a formula (e.g. a beneficiary can be made specifically entitled to a percentage the capital gain made on the sale of a particular asset). Taking into account the fact that trust resolutions are usually made in anticipation of the trust's final accounts, in practice it is rare to make a beneficiary specifically entitled to a particular amount of a capital gain and generally percentages are adopted to deal with variances which may arise when the final accounts are prepared; and

[5] See paragraph 2.65 of the EM to TLAM5.

(c) the ability of and way that the trustee to make a beneficiary specifically entitled to a capital gain will depend on the definition of Trust Income in the trust deed and the breadth of the trustee's income and capital distribution powers. In particular, there must be a trust streaming power in the trust deed which allows the trustee to specifically deal with the capital gain under either their income or capital distribution powers. If there is no trust streaming power it would not be possible to specifically stream a capital gain to a particular beneficiary.

3.7 The fact that making a beneficiary specifically entitled depends heavily on the terms of the trust deed, means that adopting pro-forma trust distribution resolutions is risky since trust deeds can vary considerably. However, the following outlines how a trustee can typically make a beneficiary specifically entitled depending on how the gross capital gain is treated for Trust Income purposes:

(a) the **gross capital gain is automatically included in the meaning of Trust Income under the terms of the trust deed or the trustee has discretion to do so** – in which case the trustee should ensure that the capital gain is characterised as forming part of the Trust Income, and separately identified as a particular class of income, to which the intended beneficiary is entitled. The trustee would then resolve to distribute the gross capital gain to the beneficiary using its income distribution power.

(b) **the gross capital gain is not included in the meaning of Trust Income under the terms of the trust deed and the trustee has no discretion to do so** – in which case the trustee should ensure that the capital gain is separately dealt with as a capital distribution, for example as an interim distribution of trust capital, to the intended beneficiaries.

(c) **only part of the gross capital gain is included in the meaning of Trust Income under the terms of the trust deed (e.g. Trust Income is defined to mean section 95 net income) –** a common example of this situation is where the trust derives a capital gain subject to the 50% CGT discount. Since only 50% of the gross capital gain is included in Trust Income the trustee can only make a beneficiary specifically entitled to 50% of the gross capital gain under the trustee's income powers. To ensure that the intended beneficiary is specifically entitled to 100% of the gross capital gain, the trustee would need to use its capital distribution powers to distribute the remaining 50% of the gross capital gain to the intended beneficiary.

3.8 Unlike the concept of present entitlement, a beneficiary can be made specifically entitled to a capital gain up to two months after the end of the relevant income year when the trust derived the capital gain.[6] (Note also in contrast a specific entitlement to a franked dividend must be made by year end.[7]) The two month period of grace aims to cover capital gains on transactions that straddle two income years.

A beneficiary's share of the net financial benefit of the capital gain – what a beneficiary reasonable expect to receive

3.9 Under section 115-228 Tax Act 1997, beneficiaries are specifically entitled to a capital gain only to the extent they have 'received or can reasonably be expected to receive' the capital gain. In determining whether a beneficiary's share of the net financial benefit of a capital gain, you look at the financial benefit to the trust over the life of the relevant CGT asset and not just in the year of the CGT event.

[6] Section 115-228(1)(c) Tax Act 1997.
[7] Section 207-58(1)(c) Tax Act 1997.

3.10 Example 2.3 of the EM illustrates the need to track the financial benefit over the full life of the asset as follows:

> *The Zhang Trust buys an investment property in 2001 for $100,000. The trustee of the trust has the power to revalue the property according to generally accepted accounting principles and treat any increase in its value as income of the trust.*
>
> *Each year for the following 10 income years, the trustee revalues the asset upwards by $20,000 and treats this amount as income of the trust. For each of the first five years, the trustee distributed $20,000 from the revaluation to John, who is no longer a beneficiary of the trust. For each of the remaining five years, the trustee distributed $20,000 from the revaluation to Kevin (who is still a beneficiary of the trust).*
>
> *In the 2011-12 income year, the trustee sells the property for $400,000. The trustee makes an accounting gain of $100,000 ($400,000 less the revalued amount of $300,000) and a (tax) capital gain of $300,000 ($400,000 capital proceeds minus the cost base of $100,000).*
> *The trustee distributes the $100,000 accounting gain to William.*
>
> *Assuming there are no losses or expenses, the net financial benefit referable to the gain (over the life of the asset) is $300,000. After applying the CGT discount, the taxable capital gain is $150,000.*
>
> *Kevin received a $100,000 share of the net financial benefit referable to the gain (in five payments of $20,000) and therefore is specifically entitled to one third of the $300,000 capital gain.*
>
> *William also received a $100,000 share of the net financial benefit referable to the gain (one payment of $100,000) and is also specifically entitled to one third of the $300,000 capital gain.*
>
> *There is one third of the capital gain to which no beneficiary is specifically entitled. (John cannot be specifically entitled to any of the capital gain because he is no longer a beneficiary.)*

3.11 The one third of the capital gain to which no beneficiary can be made specifically entitled, would instead be assessed to the beneficiaries who are presently entitled to other trust income (not being capital gains or franked dividends) according to their proportionate entitlements to Trust Income. This would be an inappropriate result given that the other beneficiaries did not receive the benefit of that one-third capital gain which has otherwise been distributed to John.

3.12 There had always been a residual concern that section 99B Tax Act 1936 would render a trust revaluation strategy ineffective by taxing the distribution of the unrealised gain in the hands of the recipient. In a sense the financial benefit requirement of a specific entitlement quietly puts another parameter on the revaluation and distribution of an unrealised gain strategy by requiring that the trust beneficiaries who receive the benefit of distributions of unrealised gains to continue to remain beneficiaries of the trust. Where one is dealing with a trust restructure that involves the removal of a beneficiary, one should check that no such revaluation strategy has been adopted in the past.

No one can be specifically entitled to a 'deemed gain'

3.13 The requirement that a beneficiary must receive the financial benefit of the capital gain also means that a notional capital gain cannot be specifically streamed. Examples of notional capital gains include:

(a) a notional capital gain arising from the application of the market value substitution rules in sections 112-20 and 116-30 Tax Act 1997. Section 112-20 can deem a lower market value cost base leading to a higher capital gain. Similarly 116-30 can lead to a higher capital gain as a result of higher deemed capital proceeds. In such a case a beneficiary can only be made specifically entitled to the capital gain calculated without taking into account the market value substitution rules;

(b) a deemed capital gain which the trustee makes on non-taxable Australian property when the trust ceases to be an Australian tax resident.[8] No part of this deemed capital gain can be made specifically entitled to a beneficiary since there is no economic benefit referable to the gain the beneficiary receives.

Trust tax losses generally

3.14 The principle underlying the amended law is that trust tax losses are first recouped against income other than capital gains but, once all of that other income is offset, the remaining tax losses are proportionally recouped against those capital gains.

3.15 This is the effect of sections 115-225 Tax Act 1997 and means that both specifically distributed and generally distributed capital gains are proportionally reduced. Although this means that losses cannot be skewed to offset one or the other of the capital gains, this would not seem to be disadvantageous – as the reduction is of net capital gains, after capital losses and CGT discount would not be lost until there is no trust net income at all.

Application of capital losses must

3.16 When determining a beneficiary's share of the net financial benefit referable to a capital gain, the gross financial benefit is reduced by trust losses or expenses only to the extent that capital losses are applied in the same way. If there is an inconsistency between the way the trustee applies trust losses against the capital gain for trust purposes and the way the trustee applies capital losses against the gain for tax purposes, then a beneficiary may not be made specifically entitled to the whole capital gain. This is because the net financial benefit of the capital gain is only reduced to the extent that losses are applied in the same way as capital losses for tax purpose. Example 2.2 of the EM illustrates this:

> *A trust sells Asset A for a gain of $1,000 and Asset B for a gain of $2,000. The trust also sells another asset for a capital loss of $500. (The amounts are the same for trust and tax purposes.)*
>
> *The trustee resolves to distribute $500 to Jo, recorded as referable to the gain on Asset A after being reduced by the capital loss, and $2,000 to Tanya, recorded as referable to the gain on Asset B. However, for tax purposes, the trustee applies the capital loss against the capital gain on Asset B.*
>
> *Therefore, the net financial benefit referable to the capital gain on Asset A is $1,000, and Jo is only specifically entitled to half of the capital gain. The net financial benefit referable to the capital gain on Asset B is $2,000 (because the trustee did not apply any trust losses against the trust gain) and Tanya is specifically entitled to all of the capital gain.*

Specific entitlement rather than present entitlement to Trust Income

3.17 As the concept of specific entitlement looks at an entitlement to the net financial benefit of a capital gain, it is not wedded to the concept of Trust Income. This can be beneficial in a situation where a trust derives no Trust Income but yet has made a taxable capital gain. This situation

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[8] CGT event I1 (section 104-170 Tax Act 1997).

can occur where the definition of Trust Income for the trust is fixed to income according to ordinary concepts without any power for the trustee to include capital gains in Trust Income. Prior to the introduction of the TLAM5 amendments such a capital gain would have been taxed to the trustee under section 99A Tax Act 1936 since there was no trust income to make a beneficiary presently entitled to. Since these amendments, this penal taxation can be avoided by making a beneficiary specifically entitled to such a capital gain via a capital distribution.

Is specific entitlement always the way to go?

3.18 When considering how to distribute a capital gain, it is not always the case that a beneficiary must be made specifically entitled to the capital gain. Where all intended beneficiaries are individuals who are intended to share equally in all Trust Income, it may be easier not stream and to just distribute in percentages, relying on the provisions of Subdivision 115-C Tax Act 1997 to apportion the capital gain across the beneficiaries according to those percentages.

3.19 Additionally, where a significant individual must be created through trust distributions so as to access the small business CGT concessions, counter intuitively it can sometimes be easier to generate the necessary 20% small business participation percentages by not streaming at all.

Part 2 – trust restructures

4 Typical trust restructure transactions

4.1 Whilst trusts provide a number of tax advantages that make them especially appealing to the SME market (e.g. income splitting and the 50% CGT discount), tax wise they can be unwieldy structures when there is a need to restructure the terms of the trust or the asset holdings of the trust. This is because there are few CGT rollovers available to trusts.

4.2 Usually the primary driver of a trust restructure is a change in the family situation of the beneficiaries of the trust, rather than a tax purpose. However, where a trust has significant assets material a trust restructure can inadvertently trigger CGT and stamp duty issues.

4.3 There can be a myriad of CGT events applicable to a trust restructure ranging from the general CGT events A1 and C2 to the specific 'E events' for trusts. This section of the paper focuses on the following types of restructures:

(a) an 'internal' variation of the trust;

(b) the distribution of trust assets out of the trust; and

(c) the vesting of a trust and the concept of 'absolute entitlement'.

5 Variation of the terms of a trust

Trust resettlements

5.1 Over time the situations of trust beneficiaries may alter and similarly the law may changes occur (for instance *Bamford)* which prompt a desire to change the terms of the trust. This can include:

(a) adding or deleting beneficiaries;

(b) altering income and capital powers or beneficiary entitlements; and

(c) varying administrative provisions related to trustee powers and the position of trustee and appointor.

5.2 Historically, the biggest concern to tax advisers when varying the terms of a trust is whether such a variation triggers a resettlement of the trust. Broadly where a resettlement occurs the existing trust relationship is ended and a new trust is created. Where a resettlement occurs CGT events E1 (section 104-55 Tax Act 1997 – creation of a trust by settlement or declaration) or E2 (section 104-60 Tax Act 1997 – transfer to an existing trust) may occur. Additionally, stamp duty liabilities are triggered where the assets of the trust represent dutiable property.

5.3 Changes to the administrative provisions of a trust deed will not trigger a resettlement. However, where there are significant changes to the terms of a trust, particularly in relation to the entitlements of a beneficiary the issue of whether a trust resettlement occurs needs to be broached.

5.4 The concept of a 'resettlement' is not defined in legislation but rather it takes its meaning from case law which has struggled to provide a clear definition. In *Davidson v Chirnside* (1908) 7 CLR 324 at 340, Chief Justice Griffith suggested that a settlement was anything which purported to be 'a charter of future rights and obligations'. Previously, the ATO in its document titled 'Creation of a New Trust – Statement of Principles August 2001' suggested that a resettlement occurs where a variation caused a fundamental change to the existing trust relationship. The question raised by the ATO's conception of a resettlement was what was a fundamental change?

5.5 The ATO's previous conception of a resettlement was always suspect because it failed to take into account the reasoning in the High Court decision of *FCT v Commercial Nominees of Australia Ltd* (2001) 75 ALJR 1172 which suggested that it was much harder to trigger a resettlement than suggested by the ATO. The incorrectness of the ATO's view on resettlements was later borne out in the Full Federal Court decision of *Clark v FCT* [2011] FCAFC 5.

5.6 *Clark* was a loss trafficking case, rather than a case on resettlements per se. In *Clark* prior year capital losses were incurred by the trust at a time when it was controlled by the Denoon family. Control and benefit of the trust was then transferred to another family (the Clarks) so that they could take advantage of the capital losses. When the trust (under the control of the Clarks) duly made a capital gain and sought to offset it against prior year capital losses, the Commissioner sought to deny those loss deductions on the basis the trust was not the same taxpayer who incurred the capital losses. That is, the changes to the trust on its transfer to the Clarks were so fundamental that a resettlement had been triggered.

5.7 The changes made to the trust included:

(a) a change of trustee;

(b) a complete change to the unitholding in trust;

(c) a change to trust property except for the $10 settlement sum;

(d) changes to the old trustee's right of indemnity;

(e) a discharge of trust liabilities; and

(f) a change from being a dormant loss trust to an active trust.

5.8 The Full Federal Court in *Clark* relied upon the High Court decision in *Commercial Nominees* in holding that the continuity of the trust estate did not necessarily require continuity of the trust property or the beneficiaries, provided that such changes were contemplated by the trust deed.

Consequently the Court ruled no resettlement had occurred on the transfer of the trust to the Clarks.

5.9 More specifically, the Full Federal Court stated that:

> *"87 … When the High Court in Commercial Nominees spoke of trust property and membership as providing two of the indicia for the continued existence of the eligible entity or trust estate, the Court was not suggesting that there had to be a strict or even partial identity of property for the first and objects for the second. It was speaking more generally: that there had to be a continuum of property and membership, which could be identified at any time, even if different from time to time; and without severance of one or both leading to the termination of the trust in question…*
>
> *88 …Such an approach is consistent with the position at general law in relation to the four essential indicia of the existence of a trust: the trustee, trust property, the beneficiary and an equitable obligation annexed to the trust property*."

5.10 The Full Federal Court additionally considered that the High Court in *Commercial Nominees* endorsed its resettlement test in the earlier case of *FCT v Commercial Nominees of Australia Ltd* 99 ATC 5115. Under that test a trust deed amendment will not trigger a resettlement provided it is in accordance with the variation power conferred in the trust deed and there is continuity of the property subject to the trust obligation (which usually will be the case because of the settlement sum), notwithstanding any amendment of the trust obligation and any change in the property itself.

5.11 Subsequent to the handing down of *Clark* the ATO withdrew its Statement of Principles and issued Taxation Determination TD 2012/21 where it grudgingly accepted the reasoning in *Clark*. The consequence of *Clark* and TD 2012/21 in practice is that `trust deeds can generally be amended without CGT consequences, provided the amendment is in accordance with the trustee's power under the trust deed.

5.12 Even where a trust variation triggers no CGT consequences – because there is no resettlement, it is also necessary to consider whether the variation triggers stamp duty in the particular jurisdictions where the trust holds dutiable property. For instance, whilst the deletion of a default beneficiary for a trust that only holds NSW based property will not trigger NSW stamp duty consequences. This may not necessarily be the case for a trust with Queensland property.[9]

Murdoch Trust Case

5.13 *Murdoch v FCT* 2008 ATC 20-031 is not a trust restructure case but it highlights the fact that when dealing with trusts it is always necessary to have regard to trust law. The taxpayer in that case was the late Dame Elisabeth Murdoch who had a life interest in several trusts established by her late husband. In 1994 the taxpayer entered into a settlement deed with the current and former trustees of the trusts under which the taxpayer was paid $85 million in return for releasing the trustees from alleged breaches of trust caused by pursuing an investment policy which favoured the remainder interests to the detriment of her life interest. Ostensibly this investment policy involved investing in News Corp shares which notoriously paid minimal dividends.

5.14 The Commissioner sought to tax the $85 million as ordinary income on the basis that it was compensation for a release of an entitlement which would otherwise have been assessable income.

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[9] There is a family trust exemption in section 118 *Duties Act 2001* (Qld) which may prevent stamp duty occurring in this situation where the deleted default beneficiary is a family member of a family trust.

5.15 The taxpayer argued that her claim was not a claim for compensation of lost income, but instead a claim to have the trustees account for capital profits made as consequence of their breach of trust by pursuing that investment strategy. Additionally in accordance with the principles of *Phipps v Boardman* [1967] 2 AC 46, the breach of trust created a charge or constructive trust was created over the capital of the trusts in her favour. The settlement sum was thus capital as it was paid in respect of these capital claims.

5.16 The Commissioner's argument was rejected by the Full Federal Court which accepted the taxpayer's reasoning that the settlement sum was capital in nature. The taxpayer's position as a life beneficiary was considered irrelevant.

6 Distribution of the trust assets out from the trust

6.1 Distributing assets and trust capital from a trust to a beneficiary is a common trust transaction. However, various CGT issues may arise when entering into such a transaction which includes:

(a) the need for clarity as to the relevant CGT Event to apply to the transaction, especially where the recipient beneficiary is a trust;

(b) CGT consequences of in specie distributions; and

(c) the applicability of CGT Event E4 on distributions of trust capital to a beneficiary of a fixed or unit trust.

Disposal of trust assets to another trust

6.2 Often where beneficiaries are in dispute about the control of a trust, there is a desire to split the trust into two so that warring beneficiaries can go their own way with two separate trusts holding a portion of the original trust's assets. Where a trust has fixed beneficial entitlements (e.g. a unit trust) there is a CGT rollover in Subdivison 126-G Tax Act 1997 that can achieve such desired separation.

6.3 For discretionary trusts since the Government ended the CGT trust clone exception for transfers between trusts which had the same terms and beneficiaries on 1 November 2008, there is no way to undertake such a trust clone with triggering CGT consequences.

6.4 Where a trustee distributes trust assets to a trust beneficiary, it is possible for more than one possible CGT event to apply to the transaction, namely:

(a) CGT event A1 (disposal of an asset); or

(b) CGT event E2 (transfer of asset to existing trust)

6.5 In such a circumstance, the most specific CGT event will apply.[10] However, identifying the correct CGT event can become difficult. What CGT event applies can be important because of the timing of the CGT event – CGT event A1 occurs on entry into contract whilst CGT event E2 occurs when the asset is transferred. This difference in timing can be important in assessing whether the 12 month requirement of the CGT discount has been met.

6.6 In *Healey* v *FCT* [2012] FCA 269 the Federal Court considered whether CGT event A1 or CGT event E2 should apply to a transfer of an asset to an existing trust, and considered that CGT event E2 was the more appropriate CGT event to apply. The effect of this was to deny the taxpayer in *Healey* the ability to claim the CGT discount.

[10] Section 102-25 Tax Act 1997

6.7 This ruling conflicted with the the ATO's view on the issue as outlined in ATO ID 2003/559 which provides that:

(a) CGT Event A1 would be the more specific event where the parties are unconnected and are dealing with each other at arm's length; and

(b) CGT event E2 will be the most specific event if, for example, an asset is transferred to a trust of which the transferor or an associate is a beneficiary or object.

6.8 In a meeting of the ATO's NTLG Losses & CGT Sub-committee meeting on 12 June 2013 the ATO was asked whether it continued to hold its view in ATO ID 2003/559 given that the Federal Court had not considered whether the parties were connected with each other in making its ruling. The ATO responded by saying that it would wait for the Full Federal Court appeal of *Healey* before commenting. Unfortunately the Full Federal Court appeal in *Healey v FCT* [2012] FCAFC 194 did not address the matter because the parties already agreed that CGT event E2 was the more appropriate CGT event. Consequently the issue is not entirely clear, though the ruling in the earlier Federal Court case of *Healey* was not challenged and so arguably remains the law – i.e. CGT event E2 is the more appropriate CGT event.

Splitting trusteeship

6.9 The CGT consequences of breaking up a trust into two trusts can be prohibitive, and one alternative trust restructure is to split the trusteeship of assets of the trust between the two warring beneficiaries. That is, Beneficiary 1 is appointed trustee for a particular X asset and Beneficiary 2 is appointed trustee for a particular Y asset. There is no trust split per se, as there is still one trust. However, the splitting of trusteeship gives each beneficiary more control over a particular trust asset.

6.10 Provided the splitting of trusteeship is carried out properly and there are appropriate provisions in the trust deed to allow for split control, no CGT or stamp duty liabilities should be triggered.

6.11 This benefit of added control must, however, be tempered with the fact that since there is still one trust, the warring beneficiaries will still need to cooperate given that one set of accounts and tax returns needs to be lodged for the trust. Additionally, tax attributes such as trust losses are shared between beneficiaries and cannot be technically hived off to one particular beneficiary. Whilst this solution of splitting trusteeship has such issues, it represents a half way house to the goal of separate control.

Distribution of a trust asset by way of in specie distribution

6.12 CGT Event A1 will apply to an in specie distribution of trust property to a beneficiary. The market value substitution rule in section 116-30 Tax Act 1997 will apply to deem the beneficiary to have provided the trustee with capital proceeds equal to the market value of the asset distributed. This is because either the beneficiary provided no capital proceeds for the distribution or because the trustee and beneficiary would be considered to be dealing with each other at arm's length.

6.13 The fact that the trustee may be taxable on a capital gain made on an in specie distribution without any receiving any funds to pay the tax, means that in specie distributions should be avoided except in the case where the trust has either:

(a) trust losses; or

(b) a cost base in the asset higher than market value.

Distributions of monetary trust capital to beneficiaries of discretionary trusts

6.14 Distributions of monetary trust capital to a discretionary beneficiary should not trigger CGT provided the distribution is done immediately and does not cause a resulting trust interest to arise. That is, the trustee resolves to pay trust capital to the discretionary beneficiary and immediately makes a payment rather than leaving the resolution as an unpaid entitlement.

6.15 This conclusion relies on the fact that at law a beneficiary of a discretionary trust does not have an interest in specific assets of the trust. This stems from the trusts law principle that a discretionary beneficiary merely has a 'right to be considered' for the application of one or more of the trustee's powers under the trust deed.[11] Note the courts have held that the interest of a default beneficiary can constitute a vested, but defeasible, proprietary interest in a trust.[12]

6.16 On the basis that a discretionary beneficiary has no 'interest' in the trust, the payment of a monetary amount of trust capital will not trigger CGT Event E4. This is accepted by the Commissioner in Taxation Determination TD 2003/8. A discretionary beneficiary for these purposes includes discretionary capital beneficiaries in hybrid trusts provided that the terms of the trust deed are worded appropriately. Interestingly, the Commissioner also takes the view that a default beneficiary of a discretionary trust also does not have a sufficient interest for CGT event E4 to occur.[13]

6.17 Because of its wide drafting, there is also a view that section 99B Tax Act 1936 could have potential application to capital distributions from a trust which comprise accumulated income. Section 99B's exact operation is yet to be fully determined. In *Traknew Holdings Pty Ltd v FCT* (1991) 21 ATR 1478 Justice Hill suggested that its operation may be confined to non-resident trusts, however, literally it can apply to resident trusts. The current practice of the Commissioner is not to seek to apply section 99B to capital distributions from a resident trust.

Distributions of capital to unitholders of unit trusts

6.18 In contrast to discretionary trusts, distributions of capital to a unitholder can have CGT implications under CGT event E4.

6.19 CGT event E4 applies where:

(a) the trustee of a trust makes a payment to a taxpayer in respect of their unit or their interest in the trust (except for CGT event A1, C2, E1, E2, E6 or E7 happening in relation to it); and

(b) some or all of the payment (the **non-assessable part**) is not included in the taxpayer's assessable income.

6.20 It is relatively common for non-assessable amounts to be included in a distribution, giving rise to a difference in 'tax law income' and 'trust law income'. That is, the net income of the trust (calculated in accordance with section 95 Tax Act 1936) exceeds the income of the trust available for distribution (calculated in accordance with the deed). This difference could arise for several reasons, including:

(a) expenses chargeable against trust income for that income year but not deductible in that income year;

(b) the small business 50% reduction; or

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[11] Gartside v Inland Revenue Commissioner (1986) AC 553
[12] Queensland Trustees v. Commissioner of Stamp Duties (1952) 88 CLR 54 at page 63)
[13] Taxation Determination TD 2003/28

(c) building allowances in accordance with Division 43 Tax Act 1997.

6.21 Ultimately, the objective of CGT Event E4 is to increase the tax payable by a unitholder in situations where non-assessable amounts would not otherwise be included in the unitholder's assessable income. The capital gain sheltered by way of the 50% CGT discount is **not** considered as a non-assessable part of a taxpayer's assessable income.

6.22 If CGT Event E4 is triggered, the cost base of the units is reduced by the non-assessable amount (but not below nil). The taxpayer will make a capital gain if the non-assessable part of the distribution is more than their cost base. However, it is possible to apply the general 50% discount to any capital gain, provided that the taxpayer is not a company and has held its units for longer than 12 months.

6.23 The fact that distribution of amounts sheltered by the small business 50% reduction trigger CGT event E4 means that more tax planning is required when a unit trust sells an active business. The amount of the capital gain made by the unit trust on the sale which are sheltered by the 50% CGT discount flows out to unitholders tax-free as they are excluded from CGT event E4's operation. The amount sheltered by the small business 50% reduction is not excluded and so unitholders may make a capital gain the receipt of the amount. Where the trust only held active business assets, then the units themselves may be active assets for the purposes of the small business CGT concessions and the benefit of those concessions may be claimed to reduce the capital gain made under CGT event E4.

6.24 For passive rent earning property trusts the operation of CGT event E4 can lead to double taxation, when amounts sheltered by Division 43 building depreciation are paid out. This because the unit trust would claim building depreciation at the unit trust level and these depreciation deductions will operate to write down the cost base the unit trust has in the property.[14] If the unit trust distributes amounts sheltered by the building depreciation deductions at unit trust level, to unitholders then their cost bases in their units will be reduced by CGT event E4. When the unit trust then later sells the property, its capital gain would be increased by the amount which the building depreciation deductions wrote down the unit trust's cost base in the property. This extra taxable capital gain represents double taxation of the amount which had previously been distributed to unitholders and taxed to them under CGT event E4.

Lew Trust Dispute

6.25 *Lew v Priester* [2012] VSC 57 concerned the Lew Custodian Trust, a family discretionary trust which was established by Solomon Lew. In 1999, the Trust entered into a verbal arrangement with each of Solomon and Rose Lew's children, Peter, Jacqueline and Steven. Under the arrangement each child was to receive $170 million as a distribution of corpus, but would only receive $25 million in a loan account in their own names, with the balance of $145 million to be gifted back to the trust. The arrangement was designed to circumvent a Government proposal to tax undistributed profits accumulated within a trust, which ultimately was never implemented.

6.26 Steven Lew and Jacqueline Lew subsequently divorced their respective partners and the *Lew Case* related to whether their former spouses could claim trust entitlements in their divorce proceedings. Solomon Lew brought proceedings in the Supreme Court to clarify the verbal agreement to ensure that he and Rose had the sole beneficial interests to the amount distributed in an attempt to keep the $25 million loan accounts out of reach of the former spouses. The dispute was settled out of court in 2012.

6.27 In the context of distributing corpus out of the trust, given that the trust was a discretionary trust, CGT Event E4 did not apply and the distributions were tax-free. However, a key takeout from this dispute is the need to consider the commercial and practical effects from distributing

[14] Section 110-45(1B) Tax Act 1997.

trust capital and the creation of loan accounts which are assets in themselves. Although Solomon could not have known that his children would have been subject to a divorce, he could have considered distributing the corpus to a more suitable asset protection entity.

7 Vesting a discretionary trust

7.1 To wind up (or vest) a discretionary trust is to end the trust relationship and distribute the trust property to the beneficiaries pursuant to trusts law and the trust instrument.

7.2 A trust can vest in the following situations:

(a) vesting day arrives under the terms of the trust deed; or

(b) the trustee exercises a discretion to bring vesting day forward (if there is such a power under the trust deed); or

(c) the trustee distributes all of the trust property pursuant to a power under the trust deed – this collapses the trust because a trust needs property to exist.[15]

7.3 Key points in relation to CGT consequences of a trust vesting are:

(a) In winding up a discretionary trust, depending on the wording of the trust deed a beneficiary may become absolutely entitled to an asset before receiving the legal title to the asset, particularly if the winding up occurs due to the arrival of the vesting day. In that case CGT Event E5 applies, rather than CGT Event A1. If legal title to the asset is later transferred to that beneficiary, there is no further tax consequence.[16]

(b) Where CGT Event E5 is triggered the trustee makes a capital gain if the market value of the asset is more than its cost base. CGT event E5 can also create a capital gain or loss for the beneficiary in respect of their trust interest[17] – but the gain or loss is disregarded where the beneficiary did not incur expenditure for the interest, which will be the case for a discretionary beneficiary.[18]

(c) As indicated above if the trustee makes a beneficiary absolutely entitled to a trust asset, CGT Event E5 will result in the trustee making a capital gain if the market value of the asset exceeds its cost base. However, under the ordinary operation of Division 115-C Tax Act 1997, it is not certain whether the creation of the absolute entitlement alone is enough to create a specific entitlement – for example whether a failure to record the entitlement in the trust's accounts as such a specific entitlement will cause the specific entitlement to fail. In that case, if income of the trust for that year is distributed to other beneficiaries, they may bear the CGT liability arising from the asset which another beneficiary now absolutely and beneficially owns.

(d) Where a beneficiary has been first made absolutely entitled to a CGT asset and then the trustee sells the asset, section 106-50 Tax Act 1997 operates to 'look through' the trust and cause the beneficiary to make a capital gain. This means that any capital gain or loss arising from the sale of the asset is made by the beneficiary and not the trustee – though the beneficiary will not usually have a gain because they received a market value cost base upon becoming absolutely entitled to the asset.

[15] Port of Brisbane Corporation v ANZ Securities Ltd (No. 2) [2003] 2 Qd R 661 at [29].
[16] Section 106-50 Tax Act 1997
[17] Section 104-75(5) Tax Act 1997
[18] Section 104-75(6) Tax Act 1997

(e) If you wish to vest a unit trust, it may be more tax effective to pay out monetary amounts held by the trust prior to collapsing the unit trust. This is because amounts sheltered by the 50% CGT discount can pass through without triggering CGT event E4 since they are specifically excluded from CGT event E4's operation. If you collapse a unit trust by redeeming units, CGT event C2 occurs. Unlike CGT event E4, amounts sheltered by the CGT discount are not excluded from CGT event C2's operation. This means those amounts will represent capital proceeds paid to end the unit under CGT event C2 and so feed into the taxable capital gain made under CGT event C2.

Absolute entitlement

7.4 The above discussion indicates that the major CGT issue when a trust vests is whether CGT is triggered under CGT event E5 – that is, if the vesting causes a beneficiary to become 'absolutely entitled' to a trust asset.

7.5 The concept of 'absolute entitlement' is important not only in the trust vesting situation but in other CGT situations. For instance, section 106-50 Tax Act 1997 provides for a look through approach when considering the CGT consequences of the disposal of an asset by a trustee of a trust where a beneficiary is absolutely entitled to the asset. Section 106-50 operates to ignore the trust relationship and treat the beneficiary as the relevant taxpayer who bears the tax consequences of such a disposal.

7.6 Certain CGT events also make specific reference to the concept of 'absolute entitlement' being:

(a) CGT event E1 – creating a trust over a CGT asset;

(b) CGT event E2 – transferring a CGT asset to a trust;

(c) CGT event E3 – converting a trust to a unit trust; and

(d) CGT event E5 – beneficiary becoming entitled to a trust asset.

7.7 Both CGT events E1 and E2 are expressly excluded from applying where the taxpayer is the sole beneficiary of the trust, the beneficiary is absolutely entitled to the asset as against the trustee and the trust is not a unit trust.

7.8 Commercially trusts where a beneficiary is absolutely entitled have been used in situations where unrelated parties are banding together for a specific purpose and the parties wish their relations to be governed by a trust relationship, or alternatively where there is a specific legislative requirement for such a trust. Examples of commercial trust relationships which rely on the absolute entitlement concept include:

(a) leveraged leases where a trustee may hold assets on behalf of investors;

(b) instalment warrant arrangements including superannuation fund borrowing arrangements;

(c) joint ventures and certain property ventures where the venture property is transferred to a trustee to hold for the benefit of the joint venture parties;

(d) certain investor directed portfolio service (IDPS) arrangements on wrap platforms where there is an intention that the investor may derive capital gains from their investments;[19] and

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[19] These commercial examples noted by Dr Gerry Bean in 'Tax treatment of beneficial ownership, equitable interests and "absolutely entitled" interests', 46th Victorian State Convention, 11-13 October 2007 at 12.

(e) buy-sell arrangements where the insurance policies are held on trust for the principals of the business.[20]

What does it mean to be 'absolutely entitled'?

7.9 The legislation does not define what the term 'absolutely entitled' means and for a long time there was no Australian case law on the matter. This has, however, changed with the handing down of the cases of *Kafataris v DFCT* 2008 ATC 20-048, *Oswal v FCT* 2013 ATC 20-403 and *Taras Nominees Pty Ltd as Trustee for the Burnley Street Trust v FCT* [2014] FCA 1. For the purposes of this paper, the case of *Oswal* will be considered.

7.10 *Oswal* involved a resolution by a trustee of a discretionary trust appoint a part of trust corpus, being shares in a particular company, for the absolute benefit of particular beneficiaries, Mr and Mrs Oswal. The relevant part of the resolution stated:

> "…[The trustee resolves] *to appoint for the absolute benefit of the named beneficiaries below, a part of the corpus of the trust as detailed below. Henceforth the corpus so appointed and income or accretion of capital there from shall be held on separate trust and for the absolute benefit of the named beneficiaries in their own individual capacities.*
>
> *Mr Pankaj Oswal – 574 shares in Burrup Holdings Pty Ltd*
>
> *Mrs Radhika Oswal – 574 shares in Burrup Holdings Pty Ltd."*

7.11 The trustee made the trustee resolution at a time when the trust owed significant liabilities and the resolution appeared to form part of an arrangement to protect the shares from creditors.

7.12 The Commissioner argued that the trust resolution either triggered:

(a) CGT event E1 because the shares commenced to be held on a new trust for Mr and Mrs Oswal; or

(b) CGT event E5 because Mr and Mrs Oswal became absolutely entitled, as against the trustee, to the shares the subject of the trustee resolution.

7.13 Justice Edmonds ruled that the trustee resolution triggered CGT event E1 as it represented a declaration/settlement of a new trust over the shares. The fact that the trustee at the time only held the legal title to the shares and not an equitable interest in the shares was considered irrelevant. Justice Edmonds J applied High Court decisions in *DKLR*[21] and *Buckle*[22] in finding that a trustee, even without having a beneficial interest in certain property, can nonetheless validly 'declare' that the property was to be held on (a different) trust. Edmonds J also found that a 'settlement' of trust property on a new trust can occur even where such a settlement is expressly contemplated by a special power granted to the trustee under the existing trust deed.

7.14 More interestingly in *Oswal* was Justice Edmonds discussion on the concept of absolute entitlement. In *Oswal* Justice Edmonds endorsed Justice Lindgren's definition of absolute entitlement as outlined in *Kafataris*[23] stating that:

> *the expression 'absolutely entitled to the asset as against the trustee' in subs (5) of 104-55 and s 104-60 of the Act is intended to describe a situation in which the beneficiary of*

[20] See Product Ruling PR 2010/18 and item 9 of the minutes to the National Tax Liaison Group minutes, December 2010.
[21] DKLR Holding Co (No 2) Pty Ltd v Commissioner of Stamp Duties (NSW) [1982] HCA 14
[22] Chief Commissioner of Stamp Duties (NSW) v Buckle [1998] HCA 4
[23] Kafataris v The Deputy Commissioner of Taxation [2008] FCA 1454

a trust has a vested, indefeasible and absolute entitlement in trust property and is entitled to require the trustee to deal with the trust properly as the beneficiary directs".

7.15 This definition of absolute entitlement is narrow since it relies on a beneficiary having an 'indefeasible' interest which practically is hard to achieve. This means that practically it is difficult for a beneficiary to be absolutely entitled and for CGT event E5 to be triggered.

7.16 In *Oswal* Justice Edmonds found that despite the trustee resolution the beneficiaries were not absolutely entitled because heir interest in the shares was **defeasible**, because:

(a) the trustee retained a power of sale either under the trust deed or under statute and so could defeat the beneficiaries' interest in the shares by selling the shares; and

(b) the trustee still had a right of indemnity against the shares.

7.17 Edmonds J noted that the trustee's powers under the trust deed may also be augmented by trust law. Since the trust was a West Australian trust relevantly, section 28(1) *Trustee's Act 1962* (WA) applied. That section provides:

'*Where the instrument creating a trust to sell property or a power to sell property does not expressly limit the duration of the trust or power, then, notwithstanding any lapse of time or that all the beneficiaries are absolutely entitled to the property in fee simple or full ownership in possession and are not under any disability the trustee may sell the property; but in all other respects the authority conferred by this section is subject to any restrictions to which the trust or power created by the instrument is subject.*'

7.18 Edmonds J found that this statutory power of sale allowed the trustee to sell the shares even though Mr and Mrs Oswal may have absolute interests in them. Therefore, the beneficiaries' interests could be defeated by this power of sale. New South Wales, Queensland, Victoria and the Australian Capital Territory have similar statutory power of sale provisions which apply despite a beneficiary being absolutely entitled to property.[24]

7.19 Justice Edmonds rejected the argument that since the trustee resolution created a new trust, the trustee's right of indemnity in relation to the old trust did not apply to prevent absolute entitlement. This was because the provisions of the original trust deed did indicate that the trustee's right of indemnity could apply to assets outside the (original) trust fund's assets.

7.20 In light of the fact that the discretionary trust owed significant liabilities ($300 million), Justice Edmonds considered that the trustee's right of indemnity did attach to the shares covered by the trustee resolution. In addition, Edmonds J noted that a court is unlikely to allow the trustee of the trust to defeat creditors' claims by asserting that the trustee had already relinquished their right of indemnity in respect of trust property still legally held.[25]

7.21 Oswal also leaves open an important question about the right of indemnity where the trust's liabilities are in fact 'trivial'[26]. That is, even though the right technically exists, does it operate to defeat the beneficiary's absolute entitlement even while the corresponding liabilities are nil or nominal in value? This unanswered question is likely of broader importance in the use of 'absolutely entitled' trusts for particular assets, which may not have any significant corresponding liabilities.

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[24] Section 27 Trustee Act 1925 (NSW), section 27 Trustee Act 1925 (ACT), section 31 Trusts Act 1973 (Qld) and section 14 Trustee Act 1958 (Vic).
[25] [2013] FCA 745 at paragraph 91
[26] [2013] FCA 745 at paragraphs 80-81

7.22 The definition of 'absolute entitlement' adopted by *Oswal* is generally in line with the Commissioner's view of the concept in Draft Taxation Ruling 2004/D5. In that draft ruling the Commissioner made other comments surrounding the concept:

(a) a beneficiary can be absolutely entitled to an asset even though they themselves hold their interests in it in the capacity as trustee for one or more others;

(b) the fact that there is a mortgage, encumbrance or other charge over the asset in favour of a third party does not of itself prevent a beneficiary from being absolutely entitled to the asset as against the trustee;

(c) the fact that a beneficiary is under a legal disability and cannot give a trustee a good discharge (e.g. infancy or insanity) does not prevent them from being absolutely entitled;

(d) the existence of a bare trust does not in itself mean that there is absolute entitlement - the concept of a bare trust differs from absolute entitlement in that a bare trust merely contemplates a situation where the trustee has no active duties to perform - by contrast the Commissioner concedes that a beneficiary can be absolutely entitled to an asset under a trust where the trustee has active duties to perform;

(e) the impact of the trustee's right of indemnity on absolute entitlement is still uncertain (see *Oswal* above);

(f) it will be difficult for a beneficiary to be absolutely entitled to an asset for CGT event E5 purposes where multiple beneficiaries have interests in the asset. This is because CGT event E5 appears to operate a single beneficiary basis.

7.23 The Commissioner's last comment of multiple beneficiaries not being able to absolutely entitled under CGT event E5 is relevant for the Rhinehart Trust case.

Rinehart Trust Dispute

7.24 The Rinehart Trust case involved a Hope Margaret Hancock Trust, a discretionary family trust was established by the late Lang Hancock in 1988. The trust's net value in recent times has been estimated anywhere between \$4 billion and \$9 billion. The Trust's main asset is approximately 25% of the shares on issue in Hancock Prospecting Pty Ltd, on which significant unrealised gains exist.

7.25 Gina Rinehart was the trustee of the trust until she resigned in 2013. The beneficiaries are John Hancock, Bianca Rinehart, Hope Welker and Ginia Rinehart. The Trust was to 'vest' in the beneficiaries upon 25th birthday of the youngest child, Ginia, on 6 September 2011.

7.26 Days before the trust was to vest, Gina Rinehart as trustee advised the beneficiaries that they would incur significant CGT liabilities as a result of the vesting, and that the terms of the trust would not permit the trustee to dispose of or borrow against the shares in order to fund the beneficiaries' tax liabilities. Gina Rinehart, as trustee, had the power to vary the terms of the trust at any time prior to the vesting date, and purported to extend the vesting date, by deed of variation, to 5 September 2058 – the full 80 year perpetuity period.

7.27 However, it later emerged that there were a number of uncertainties about the CGT liabilities that were said to arise to the beneficiaries, including:

(a) whether, on the terms of the trust deed, the 'vesting' would cause a CGT event to occur;

(b) whether or not the shares in Hancock Prospecting Pty Ltd were pre- or post-CGT;

(c) whether the trustee, or the beneficiaries, would bear the CGT liability.

7.28 The Commissioner's view that a beneficiary cannot become absolutely entitled to a trust asset under CGT event E5 where multiple beneficiaries have interests in the trust asset in TR 2004/D5 suggests that the vesting of the trust did not trigger CGT event E5. This was because there are multiple beneficiaries have interests in each of the trust assets.

7.29 In October 2013, Gina Rinehart resigned as trustee, with a new trustee yet to be appointed. The dispute has been resolved in the New South Wales Supreme Court with Gina's oldest daughter, Bianca, handed control of the trust.

8 Acknowledgement

This paper has been based on material prepared by a number of the partners and staff at McCullough Robertson Lawyers.

9 Disclaimer

9.1 This paper covers legal and technical issues in a general way. It is intended for information purposes only and should not be regarded as legal advice. Further advice should be obtained before taking action on any issue dealt with in this publication.