

# Cover sheet for: TD 2012/21

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## Taxation Determination

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

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### Ruling

1. No. In these circumstances 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 unless:

- the change causes the existing trust to terminate and a new trust to arise for trust law purposes, or
- the effect of the change or court approved variation is such as 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.

**Example 1: addition of new entities to, and exclusion of existing entities from, 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. The General Beneficiaries are defined under the terms of the trust deed to be Mr Squirrel, his wife, their children, their grandchildren, and Oak Pty Ltd, a private company through which the family runs a business of growing flowers to supply local florists.

3. Having decided to get out of the flower industry, the Squirrel Family dispose of their interests in Oak Pty Ltd to an unrelated third party.

4. 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 specifically remove Oak Pty Ltd by name from the class of General Beneficiaries. The trustee further resolves to add to the class of General Beneficiaries:

- the respective spouses of the children;
- trusts and companies in which the family has a majority controlling interest; and
- a philanthropic charity unrelated to the Squirrel Family.

5. The making of these resolutions, 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**

6. 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, power to stream, and extension of vesting date**

7. The Lime Trust is a discretionary trust settled in 1980 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. The deed contains a clause specifying the date on which the trust is to vest as 30 September 2020.

8. 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 subsection 95(1) 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).
9. The trustee further resolves to amend the deed by changing the vesting date to 30 September 2050 or such earlier date as the trustee may determine.
10. The making of the resolutions, 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**

11. The Hedgerow Trust is a discretionary trust the class of objects of which consists of a large number of entities associated with the Buttercup family. Under its terms, 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 or more of the trust objects to the exclusion of the other objects of the trust. In exercise of this power, the trustee declares that one of several assets forming part of the corpus of the trust – asset 1 – was henceforth held exclusively in trust for one of the objects, Mr Badger (subject to the trustee's other powers, such as its power of sale). One month later the trustee makes a second declaration to similar effect in favour of Mr Badger in respect of one of the remaining assets of the Hedgerow Trust (asset 2). While the respective declarations do not terminate the Hedgerow Trust, the effect of the declarations is that assets 1 and 2 are no longer held on that trust. Rather, the trust obligations attaching to those assets have changed in a manner consistent with a conclusion that the assets have commenced to be held on the terms of a separate trust for the benefit of Mr Badger as sole beneficiary. As a result, CGT event E1 happens when the separate trust for the benefit of Mr Badger is created over asset 1. CGT Event E2 happens when asset 2 is also transferred to that separate trust.

**Date of effect**

12. Subject to the exception mentioned in paragraph 13, this Determination applies 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).

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13. In any case where the views expressed in this 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.

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**Commissioner of Taxation**

24 October 2012

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## Appendix 1 – Explanation

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**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 binding public ruling.*

14. CGT event E1 happens if a trust is created over a CGT asset by declaration or settlement (subsection 104-55(1) of the ITAA 1997). 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***

15. 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.<sup>1</sup> 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.

16. 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 gains 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***

17. 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 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.

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<sup>1</sup> 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.

18. *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.

19. The Commissioner has explained his view on the administrative impact of the Court's decision in the following terms:<sup>2</sup>

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.

20. 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.

21. 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*,<sup>3</sup> 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:

<sup>2</sup> See the Commissioner's Decision Impact Statement in respect of *Clark*.

<sup>3</sup> See at paragraph [78] and [79].

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.

22. The Commissioner formerly 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 at the time, 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.

23. However in light of the Federal Court's decision in *Clark*, and the High Court's disposal of the Commissioner's special leave application, it is apparent that continuity of trust is a function of whether the trust continues in existence under trust law in contradistinction to having terminated. As so understood, the comments made by the Federal Court in *Commercial Nominees* relating to amendments to trust obligations represent good law.

***Effect of a change in the terms of a trust pursuant to a valid exercise of a power in the deed or court approved variation***

24. 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 or E2 may happen as a result of changes being made to the terms of an existing trust pursuant to a valid exercise of a power in the deed (including a power to amend). In light of those principles, the ATO accepts that a change in the terms of the trust pursuant to exercise of an existing power (including an amendment to the deed of a trust), or court approved variation,<sup>4</sup> will not result in a termination of the trust and, therefore, subject to the observation in paragraph 27 below, will not result in CGT event E1 happening.<sup>5</sup>

<sup>4</sup> Under many of the State and Territory Trustee (or Trusts) Acts, the trustee of a trust (or other relevantly interested person) can in certain instances approach the relevant Supreme Court to have a trust varied on behalf of certain persons (such as infants or persons suffering some other incapacity). The precise tests defining the extent of the Court's jurisdiction differ from State to State (or Territory). Commonly the Court is empowered to make such orders as it thinks fit subject to the proviso that an arrangement to vary the trust must be for the benefit of the person (or, in Western Australia, not to the person's detriment). In South Australia any person who has an interest in property held on trust (not being a charitable trust or statutory trust) may apply to the Court to have the trust varied. Before so ordering, the South Australian statute requires the Court to be satisfied as to certain things including, for example, that the variation would not unfairly favour some beneficiaries over others. See generally sections 63 and 63A of the *Trustee Act 1958* (Vic); section 81 of the *Trustee Act 1925* (NSW); sections 94 and 95 of the *Trusts Act 1973* (Qld); sections 89

25. On this basis the 'Creation of a new trust – Statement of Principles August 2001' was withdrawn on 20 April 2012.
26. Whether a purported change to a trust in exercise of a power under the deed is properly supported by the power is to be determined in accordance with principles of trust law having regard to the scope of the power properly construed.<sup>6</sup> Relevant to this question will be whether the deed itself explicitly specifies conditions (including procedural conditions) that need to be satisfied for the exercise of the power to be effective.
27. 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 change to the terms of the trust – whether by exercise of a power under the deed (including a power to amend) or court approved variation – such as to lead to the conclusion that those assets are now held on terms of a distinct (that is, different) trust.
28. 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.
29. Analogously, depending on the facts, the effect of a change to the terms of a trust 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.

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and 90 of the *Trustees Act 1962* (WA), sections 59B and 59C of the *Trustee Act 1936* (SA); section 47 of the *Trustee Act 1898* (Tas) and sections 13 and 14 of the *Variation of Trusts Act 1994* (Tas); section 50A of the *Trustee Act* (NT); and section 81 of the *Trustee Act 1925* (ACT). As to what constitutes a variation, a classic statement of the test appears in *Re Ball's Settlement Trust* [1968] 1 WLR 899 where the court described a variation as 'an arrangement, [that] while leaving the substratum, effectuates the purpose of the original trust by other means...even though the means employed are wholly different and even though the form is completely changed' (p 905).

<sup>5</sup> Where an asset is instead transferred to an existing trust, CGT event E2 will be the relevant event (subsection 104-60(1)).

<sup>6</sup> See for example *Jenkins v. Ellett* [2007] QSC 154 where the trustee was found not to have the power to vary the trust in the manner contended. Note further that invalid amendments, being of no effect, would not of themselves result in CGT events E1 or E2 happening.

## References

*Previous draft:*

TD 2012/D4

*Related Rulings/Determinations:*

TR 2006/10

*Subject references:*

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

*Legislative references:*

- ITAA 1936 95(1)
- ITAA 1997 104-55
- ITAA 1997 104-55(1)
- ITAA 1997 104-60
- ITAA 1997 104-60(1)
- Trustee Act 1958 (Vic) 63
- Trustee Act 1958 (Vic) 63A
- Trustee Act 1925 (NSW) 81
- Trusts Act 1973 (Qld) 94
- Trusts Act 1973 (Qld) 95
- Trustees Act 1962 (WA) 89
- Trustees Act 1962 (WA) 90
- Trustee Act 1936 (SA) 59B
- Trustee Act 1936 (SA) 59C
- Trustee Act 1898 (Tas) 47
- Variation of Trusts Act 1994 (Tas) 13
- Variation of Trusts Act 1994 (Tas) 14
- Trustee Act (NT) 50A
- Trustee Act 1925 (ACT) 81

*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
- Jenkins v. Ellett [2007] QSC 154
- Re Ball's Settlement Trust [1968] 1 WLR 899

*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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