

TREASURY EXECUTIVE MINUTE

Minute No.

5 August 2008

Treasurer

cc: Assistant Treasurer and Minister for Competition
Policy and Consumer Affairs**TRUST CLONING - REMOVAL OF CAPITAL GAINS TAX (CGT) EXCEPTION**

Timing: The ATO would prefer an announcement before the National Tax Liaison Group (NTLG) meeting on 3 September 2008.

Recommendation/Issue:

- That you sign the attached letter to the Prime Minister seeking his approval to amend the income tax laws to abolish the trust cloning exception to CGT events E1 and E2.

Signed/Not Signed

Signature:

...../...../2008

- If you decide not to write to the Prime Minister on these terms, that you agree to Treasury conducting targeted public consultation on how a CGT exception for asset transfers between associated trusts might be made workable.

Agreed/Not Agreed

Signature:

...../...../2008

KEY POINTS

- Generally, a CGT event happens when an asset is transferred to a trust. However, no event happens if the asset is transferred to the trust from another trust and the beneficiaries and terms of both trusts are the same. This is known as the 'trust cloning exception'.
- The exception is used primarily by high wealth persons as a succession-planning tool, allowing effective control of assets to be passed (largely within a family group) without triggering a CGT taxing point. This is contrary to the general policy of taxing capital gains when there is a change in underlying economic ownership of an asset.
- Furthermore, the trust cloning exception may be used to eliminate tax on an asset. For example, the exception can apply even if certain assets are transferred offshore to a non-resident trust, and unrealised capital gains will permanently escape the Australian tax net.
- Taxpayers face high compliance costs because uncertainty in the current law makes it difficult for them to self-assess whether the exception applies. The uncertainty also creates a significant administrative burden on the Australian Taxation Office (ATO).

Impact on the underlying cash balance of agreeing to recommendation

2008-09	2009-10	2010-11	2011-12
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* Unquantifiable.

- The original aim of the exception was to ensure that a mere change of trustee of a single trust, such as when a trustee retires, would not trigger a CGT taxing point. When the exception was inserted, there was uncertainty over whether changing a trustee created a new trust and would, but for the exception, trigger a CGT taxing point. The ATO's view now is that the mere change of trustee neither creates a new trust nor triggers a CGT taxing point, thereby removing the need for the exception.
- Tax practitioners and professional bodies strongly disagree with the ATO's current interpretation of the exception, particularly the strict view of the test of 'sameness'. There is a strong possibility of disputes and litigation with potentially uncertain results.
- The ATO is under increasing pressure to take a more flexible approach to its interpretation of the exception. In particular, the NTLG at its meeting on 3 September 2008 will be pressing the ATO to provide administrative concessions to asset transfers made within a family group that is the subject of a family trust election.
 - However, the ATO feels that this is inconsistent with the plain words of the exception and the policy intent of the provision.
- To remove uncertainty and the potential for gains on assets to escape the Australian tax net permanently, we recommend abolishing the trust cloning exception to CGT events E1 and E2. We also recommend, if required, adding a clarification that a mere change of trustee of a single trust does not create a new trust.
 - As this is an integrity measure, this should take effect from date of announcement.
- There are likely to be significant sensitivities in relation to abolishing the exception, as it is a popular tax-planning tool. The change may be seen as another attack on family trusts.
- If you decide not to abolish the exception, we request your approval to conduct targeted public consultation on how the exception can be amended to provide greater certainty to taxpayers and the ATO and to remove its potential for eliminating tax on an asset.
- The Additional Information provides further details on the above.
- Tax Analysis Division (TAD) estimates that the recommended changes will lead to an unquantifiable (but small) gain in revenue over the forward estimates. Compliance costs are expected to be low in the short term, and reduced in the long term because of decreased uncertainty and a reduction of disputes.
- The following areas have been consulted in the preparation of this minute: ATO, TAD

Manager
Capital Gains Tax Unit

Contact Officer:

Ext:
Ext:

ADDITIONAL INFORMATION

USE OF TRUST CLONING

Trust cloning is used mainly for two reasons: succession planning and asset protection. The assets involved are typically owned by high wealth individuals and are often of significant value.

As a succession-planning tool, discretionary trusts can be used to pass effective control of trust assets among beneficiaries of the trust. In a discretionary trust, effective control of the assets of the trust lies with the trustee (or the person with the power to appoint the trustee). The trustees do not have to be the same for the purpose of the trust cloning exception.

For example, assume a discretionary trust holds two assets, A and B, and there are two beneficiaries, Mary and Bill. The trustee of the original trust is changed to a corporate trustee solely owned by Mary. The trust could transfer asset A to a cloned trust, with a corporate trustee solely owned by Bill. Effective control of asset A has been passed to Bill, and control of asset B has been passed to Mary, even though they are both beneficiaries of both trusts.

Therefore, the trust cloning exception allows for a change in effective control of the asset without triggering a CGT taxing point. This is contrary to the general policy of taxing capital gains when there is a change in underlying economic ownership of an asset.

As an asset protection tool, trust cloning is used to isolate passive investment assets from the risks associated with active business assets. For example, a trust has a business with loans and other liabilities attached, plus shares and a rental property. Cloning may be used to isolate the shares and the rental property in a new trust so they do not run the risk of being taken by creditors to satisfy business debts.

There are also concerns that trust cloning can be used to eliminate tax on an asset (see ATO advice on potential problems discussed below).

ATO INTERPRETATION OF THE CURRENT LAW

ATO Determination — trust cloning exemption

In April 2004 the ATO released a determination (TD 2004/14) stating that a CGT event does not occur when assets are transferred between two trusts, provided the beneficiaries and terms of both trusts are the same. The determination also interpreted the exception as effectively providing a CGT roll-over, although an alternative view was acknowledged.

Despite the original policy intent (to provide an exception for a mere change of trustee), it was agreed that the only view open to the ATO was to accept that the plain English interpretation of the legislation was not limited to a mere change of trustee.

ATO Ruling — clarifying the ‘sameness’ test

In June 2006 the ATO released a ruling (TR 2006/4) to clarify when ‘the beneficiaries and terms of both trusts are the same.’ The ruling applies a strict test of ‘sameness’ — it requires the two trust deeds to be identical in meaning and effect.

Despite this ruling, considerable uncertainty remains. A number of aspects of the ruling are also considered contentious. In particular, the ruling requires that, if relevant, the identity of appointers and the existence or otherwise of family trust elections must be the same. Practitioners argue that the identity of appointers and any family trust elections are not 'terms of the trust'. This view may well prevail if the issues are litigated.

In recognition that these issues are contentious, the Test Case Funding Panel recommended at its meeting in July 2006 that the ATO fund suitable test cases. None has been identified to date.

Nevertheless, there is considerable pressure on the ATO to provide further clarification of the sameness test, and to adopt a more flexible approach. For example, the NTLG has asked the ATO to consider accepting transfers made within a family group that is the subject of a family trust election irrespective of whether the transfer meets the strict requirements of the statutory exception.

ATO ADVICE ON POTENTIAL PROBLEMS

Potential to eliminate tax on an asset

While the ATO interprets the exception as providing a CGT roll-over, there is not the usual CGT roll-over infrastructure. This infrastructure usually ensures that tax is merely deferred and not avoided or eliminated, and generally preserves the tax attributes of the asset (such as pre-CGT status). Without the roll-over infrastructure, the recipient of the asset may claim an inappropriate step-up in the cost base of the asset, effectively eliminating the latent CGT liability on the transferred asset.

The ATO advises that if taxpayers or practitioners argue that the asset is transferred at market value, there is a significant risk that they would be successful in litigation. If that happens, any increase in the asset's value while held by the first trustee will escape tax completely.

Furthermore, there is another way to eliminate tax on certain assets as the trust cloning exception may apply even if the asset is transferred offshore to a non-resident trust. If that happens and the asset is not taxable Australian property, any increase in such an asset's value while it was in Australia will escape the Australian tax net permanently. The main assets that are taxable Australian property are: Australian real property; particular interests in land-rich entities; and, assets used at any time in carrying on a business in a permanent establishment in Australia.

Snapshot test

The 'sameness' test applies when the asset is transferred. Therefore, two trust deeds might be changed to 'align' them, the asset transferred, then the trust deeds changed again. This allows a change in ownership and control of an asset without triggering a CGT taxing point if the changing of the trust deeds does not constitute a resettlement of the trusts, inconsistent with the original policy intent.

However, this may trigger the anti-avoidance provisions in Part IVA of the *Income Tax Assessment Act 1936*, which apply to schemes entered into with the sole or dominant purpose of obtaining a tax benefit.

Difficult to administer

The uncertainty around the current law means no trust cloning transaction can safely occur without the backing of an ATO private ruling. These private rulings require a costly and time-consuming comparison of trust deeds, leading to unsatisfactory delays.

The strict interpretation of the sameness test is difficult for many trusts to meet. For example, discretionary trusts with a widely-drawn benefit clause are unlikely to meet this test. The effect of a widely-drawn benefit clause is typically to deem as a beneficiary any trust in which a beneficiary has an interest. The trustee of the original trust is therefore a beneficiary of the new trust, and vice versa, but neither trustee, in that capacity, can be a beneficiary of its trust. Therefore, the beneficiaries of the two trusts are not the same and the trust cloning exception is not available.

Practitioners claim that this interpretation of the sameness test will mean many, or most, discretionary trusts will not meet this test for the exception — at least not without amendments to trust deeds (which may trigger Part IVA). There are other known problems, and given the enormous variation in trust deeds in circulation, it is almost certain that all the issues or problems have not yet emerged.

The ATO believes that the exception has been claimed in respect of many transactions that have failed to comply with the current law as interpreted by the ATO. This is of particular concern to tax practitioners, and a potential source of disputes and litigation. Any confirmation by the ATO of the strictness of the test is likely to generate considerable concern amongst practitioners who fear legal action from their clients should the ATO seek to reopen completed transactions.

Further, the ATO believes that some transactions have used the uncertainty around the law to achieve an inappropriate step-up in the cost base of an asset, as described above.

RECOMMENDATION

For the reasons set out above, we recommend removing the trust cloning exception. We also recommend, if required, adding a clarification that a mere change of trustee of a single trust does not create a new trust and the new trustee takes the asset with the same CGT attributes it had in the hands of the former trustee.

We further recommend that the Government announce this measure and that, because it is an integrity measure, it should take effect from the date of announcement. This will prevent a rush of practitioners attempting to take advantage of the exception.

AREAS FOR TARGETED PUBLIC CONSULTATION IF EXCEPTION IS RETAINED

If you choose not to write to the Prime Minister, we propose to conduct targeted public consultation on the issues raised above. This is likely to consist of preparing a short discussion paper, uploading it onto the Treasury website and inviting comments from interested people. The paper would not indicate a final Government position and a draft copy would be provided to you prior to its release. After this consultation, we would provide further briefing so that you can decide, in consultation with the Prime Minister, what should be done about the trust cloning exception.

Underlying rationale for the exception

The original policy rationale for the exception was to allow a change of trustee of a single trust without triggering a CGT taxing point. However, the legislation which was enacted goes further than that and allows the transfer of assets between two different trusts. A policy rationale for excepting transfers between two different trusts should therefore be developed. This would provide a framework for the other areas for consultation and the potential amendments to the trust cloning exception.

Clarifying the ‘sameness’ test

The area of greatest uncertainty and disagreement between the ATO and practitioners is the sameness test. We propose to consult on how the law should assess when ‘the beneficiaries and terms of both trusts are the same’, including what constitutes ‘terms’ of the trusts.

The ‘snapshot’ test and the potential to eliminate tax on an asset

In the context of consulting on the policy basis for maintaining an explicit roll-over, we propose to consult on potential problems relating to the snapshot test, including the Part IVA implications, and whether alternative anti-avoidance approaches might be more effective. We also propose to consult on options to prevent the transfer of an asset outside the Australian tax net without triggering a taxing point, and other potential gaps in the law.

Potential conflict between reducing uncertainty and revenue

It may not be possible to clarify the sameness test and reduce the administrative burden on taxpayers and the ATO without broadening the scope of the existing exception. If a strict test of sameness is maintained, taxpayers will likely continue to need to apply for a private ruling, increasing compliance costs.

The revenue implications of broadening the trust cloning exception have not been costed at this stage. Any subsequent proposals to amend the trust cloning exception will be costed using information obtained from the consultation.