Document 7

AUSTRALIAN TAXATION OFFICE
MINUTE PAPER

NO.

Date: #/03/2008

Assistant Treasurer

TAXATION ADMINISTRATION: TRUST CLONING

Action required by: ##

Recommendation: That you:

a) note the administrative and interpretative difficulties relating to the CGT exception that applies if an asset is transferred between two trusts with the same terms and beneficiaries, and

b) indicate whether you consider the policy as revealed by these plain words to be appropriate.

NOTED/APPROVED/NOT APPROVED **Date ____/____/_____**

KEY POINTS

1. We consider the exception is the result of a drafting error. It was intended to apply to the transfer of an asset from a retiring trustee to a new trustee of a *single* trust. But, as drafted, it applies to the transfer of an asset between *two separate* trusts. This results in considerable interpretative and administrative difficulties.

Interpretative difficulties

2. We have ruled that the terms and beneficiaries of the two trusts must be exactly the same in all respects for the exception to apply. A strict view is required by the plain words of the exception. Treasury supports this approach.

3. Consistently, we have ruled that such things as the identity of appointers and the existence or otherwise of family trust elections are 'terms' of the trust which must be the same. This approach has been heavily criticised. We acknowledge a strong alternative view. It may well prevail if the issue is litigated.

4. Further, although the exception effects a 'roll-over', it is not supported by the usual roll-over infrastructure. We have attempted to deal with parts of this interpretatively, but may well lose if the matters are litigated. The exception can arguably be used to eliminate Australian tax by stepping-up the tax cost of a transferred asset to market value. The exception can also be accessed even if the asset is sent 'off-shore' and out of Australia's taxing jurisdiction.

Copies to: (Treasury); (Treasury); (ATO); (ATO); (ATO); (ATO); (ATO)

Administrative difficulties

5. It is very difficult to make two trusts established at different times the same. Very careful drafting is required and deed terms may need to be modified – even then it may not be possible. Determining whether the drafting has been successful is also difficult. A forensic analysis of the trust deeds is required and this is generally a complex and lengthy process.

6. This entire process is neither an efficient nor productive use of Tax Office or taxpayer resources – particularly as the trusts only need to be the same at the time of the asset transfer. Also, these uncertainties mean the chance of error is high – and the consequences of error are dire. As a result, it can be expected that practitioners will be wanting binding private rulings from the Tax Office to eliminate their risks.

7. Further details regarding the interpretative and administrative difficulties confronting us is provided in Additional Information.

8. Treasury has been consulted in the preparation of this Minute and I understand they will be briefing you on the policy aspects.

9. We would be happy to participate in a round table discussion with staff from your office and from Treasury if you think that would be beneficial. I am also available to clarify any aspect of this Minute.

Chief Tax Counsel
Law & Practice

Contact Officer:
Contact Number:

ADDITIONAL INFORMATION

A CGT exception applies when an asset is transferred between two trusts that have the same beneficiaries and terms.[1] The transfer of assets pursuant to this exception is referred to by commentators as 'trust cloning' or the creation of 'mirror trusts'.

Background

The exception was inserted in 1994[2] apparently because it was thought a change of trustee resulted in the creation of a new trust. It was therefore thought a provision was needed to ensure the transfer of assets to the 'new' trust did not trigger a CGT taxing point. However, a change of trustee does not create a new trust, so arguably no exception was required. In any case, a rollover between two trusts was *never* contemplated.

For many years, we took the view that the exception should be confined to a mere change of trustee of a *single* trust. This was contentious given that, on its plain words, the exception clearly applies to the transfer of assets between *two separate* trusts.

In about 2002, we became aware that some practitioners were applying the exception to asset transfers between two separate trusts. Some also ensured the new trust paid market value for the asset and on that basis claimed the transfer caused an uplift in the asset's tax cost to market value meaning that no CGT was payable when the asset was sold shortly thereafter.

Following consultation with the Public Rulings Panel and with Treasury officers, the Commissioner agreed the only view open on the wording of the law was that the exception applied to asset transfers between two separate trusts (and was not limited to a change of trustee). This view was formalised in Taxation Determination TD 2004/14. It also said that if the exception applied, the tax attributes of the transferred asset (namely its date of acquisition and tax cost) did not change.

The release of the Determination generated broader taxpayer and practitioner interest in the exception. This prompted the release of Taxation Ruling TR 2006/4 which sets out the principles to be applied in determining whether two trusts are the same.

The Ruling takes a strict view. It says the beneficiaries of both trusts must be exactly the same. This does not mean that the deeds of both trusts must be identically worded, but that they must have the same *meaning and effect*. The test would rarely be satisfied by two trusts having identically worded deeds..

On our view, even minor differences between the two trusts prevent the exception applying. The only things that do not have to be the same are the commencement and establishment dates of the trusts; the trustees; and the persons who settle the property on the trusts.

We have taken a strict view for two reasons. The first is the wording of the provision – it says the beneficiaries and terms must be the same, not almost the same or nearly

[1] paragraphs 104-55(5)(b) and 104-60(5)(b) of the *Income Tax Assessment Act 1997* (ITAA 1997)
[2] It was inserted into the *Income Tax Assessment Act 1936* (see former paragraph 160M(3)(a)) and was reproduced in the ITAA 1997 when the CGT provisions were rewritten as part of the Tax Law Improvement Project.

the same (and as drafted in the ITAA 1936 it said 'identical'). The second is our understanding of the policy background explained above – namely, that the provision was aimed at a situation where the trustee of a single trust changes, but nothing else does, so the same outcome must be achieved as between two trusts.

Use of the exception

The exception is used mainly for succession planning and asset protection. And in some cases to merge trusts to reduce record keeping and administrative costs.

As a succession planning tool it is most suited to, and used in respect of, discretionary trusts. The exception is certainly being used to split discretionary trust assets among members of a family group, generally to pass them to the next generation.

Say a discretionary trust holds two assets – a Melbourne transport business and a Noosa holiday unit. The trust is controlled by the parents who are near retirement age and are seeking to pass control of these assets to their two children – Bill and Mary. It is intended that Bill 'have' the transport business and Mary the holiday unit.

Bill may become the sole director and shareholder of the corporate trustee. The trust may then be cloned with the new trust having a corporate trustee of which Mary is the sole director and shareholder. The holiday unit is transferred to the new trust.

Even though the beneficiaries in respect of each asset remain the same, and continue to include all family members, control of the assets has effectively been passed to the next generation without triggering a taxing point. This strategy is commonly used by high wealth individuals.

Another advantage is that the passive investment asset (the holiday unit) has been isolated from any creditors of the transport business.

Provided the transfer does not give rise to an uplift in the asset's tax cost, then the effect of the exception is to defer capital gains tax on the asset until it is sold subsequently. However, there is also the very real possibility of the exception being used to avoid tax altogether.

Interpretative difficulties

Although the same trust exception operates as a *de facto* roll-over it not supported by the usual roll-over infrastructure which ensures that gains or losses remain in the Australian tax system after the roll-over.

For example, specific CGT roll-overs may limit the availability of 'roll-over' to assets that are taxable Australian property. There is no such restriction in respect of the same trust exception. Although we have not yet seen a case where the exception has been used to send non-taxable property off-shore, in the current climate we feel this is only a matter of time.

Further, roll-overs generally provide for the cost base and reduced cost base of an asset to be retained in the hands of a transferee. In the context of the same trust exception we have ruled that a transferred asset's tax attributes are preserved. But there is a strong alternative view. That is, there is a good argument that if the trustee of the new trust pays market value consideration this results in an inappropriate uplift in the asset's tax cost. This would result in the difference between the asset's original tax cost and its market value at the date of the transfer escaping tax altogether.

Finally, we have ruled that the making of a family trust or interposed entity election is a term of the trust such that if an election has been made by the original trust, the new trust must make the same election in respect of the same family group in order for the exception to apply. But there is an alternative view (strongly favoured by practitioners) that the making of such elections is not a term of the trust – simply a choice made by the trustee under the tax laws.

Administrative difficulties

The trusts must be the same, but only at the time of the asset transfer.

The test of 'sameness' makes sense and is easily met where all that has happened is a change of trustee of a single trust. In that context, it is applied simply by satisfying yourself that the only thing that has changed in respect of the trust is its trustee. In other words, if you can see that nothing else has happened, then you can assume the beneficiaries and terms are the same.

But in the context of two separate trusts, the test can only be applied by comparing the intricacies of each trust, or perhaps by looking at the combined effect of their deeds. And this requires a forensic analysis of the relevant trust deeds which is invariably a lengthy and complex process.

In short, the drafting error means the test of sameness has been shoehorned into applying to a situation for which it is neither designed nor suited.

The Tax Office resources required to analyse the relevant deeds for the purpose of providing written advice is not sustainable. We are rapidly approaching an administrative impasse. In fact, the time required to examine deeds has significantly slowed the issue of private rulings.

For each new scenario we are asked about, we give an answer consistent with a strict interpretative view. In response, practitioners reach for another drafting technique.

The attached example demonstrates how hard it can be to make two trusts established at different times the same. The drafting required in order to iron out what may be regarded as minor differences between two trusts is intricate, time consuming and little understood (though it is becoming more so).[3] And there may be some trusts that cannot be successfully cloned because the effect of their terms, or the beneficiaries, cannot be exactly replicated.

All this seems rather pointless and a waste of resources. But given the provision's current structure we feel we have no option to proceed in this way.

The lengths to which practitioners must go in order to meet the test reek of artificiality and contrivance raises the possibility of the general anti-avoidance provision in

[3] See the article 'Tax Tips: Trust cloning – trusts with same beneficiaries and terms' *Taxation in Australia*, Volume 42 No. 7, February 2008

Part IVA of the ITAA 1936 being applied. That is, if it can be shown that the transaction, or one or more aspects of it (such as the financing of the asset transfer or the amendment of trust deeds), has been put in place with the main purpose of obtaining a tax benefit being the tax-free transfer of an asset.

These uncertainties increase the risk of practitioners (and for that matter, the Tax Office) getting it wrong.

The consequences of claiming the exception in circumstances where it is not available are dire. It will mean the transfer triggers a CGT taxing point and possibly a very large capital gain (given the tendency for the provision to be used by high wealth individuals with high worth assets) or loss of pre-CGT status.

Practitioners who now realise the strictness of the test but who did not obtain the comfort of a private ruling before undertaking transactions risk being sued by their clients should we seek to reopen these transactions on audit.

We have discussed these issues with practitioners, including the possibility of issuing further material confirming the strict nature of the test.

Their reaction has been on the one hand to criticise our strict approach as pedantic, unreasonable and unlikely to succeed if litigated. They have also expressed alarm at the prospect that completed transactions may be at risk. On the other hand, they have busied themselves in devising drafting strategies which they believe will ensure that by one means or another the two deeds can be said to have the same effect.

We have offered to fund suitable cases in the courts to test our views. To date no taxpayer has taken up this offer (though this may change as we start to issue more negative private rulings and if we restate our position publicly in a public ruling).

More generally, taxpayer unwillingness to litigate this issue severely limits the possibility of judicial clarification. Legislative clarification – which this Minute urges – is all that remains.

Conclusion

The exception has spawned a substantial trust cloning industry if discussions at practitioner forums and in professional journals are any indication. But it is not without risk for those who participate. Getting it wrong could be a disaster.

We are under pressure from practitioners to relax our stance going forward. We are also under pressure to indicate that we will not pursue completed transactions even though the exception has been claimed in circumstances where, under the Commissioner's view, it is not available.

To date we have not agreed to either request. We feel constrained by the plain words of the provision and its legislative and policy origins.

If we reach a point where practitioners feel the exception will be denied them, or if their concern over completed transactions is heightened, then we expect them to make strong representations to us, to Treasury, and government, such is the worth of the exception to them.

Example

The Smith Family Trust was established in 1970. The person responsible for settling the initial property on trust was an employee of the accounting firm used by the patriarch John Smith.

The deed provides for a broad range of potential beneficiaries, including members of John's immediate family; any entity in which any family member has an interest; and any person who has donated more than $10,000 to a named charity. However, the deed prevents the trustee or the settlor benefiting under the trust. The trust will end within eighty years from the date of the establishment of the trust.

John Smith is now in his early seventies and wishes to hand control of the trust's assets to his children. To that end a mirror trust is established. It has a different trustee and the settlor is an employee of the law firm advising John in relation to this transaction. The deed says the new trust will end within eighty years from the date on which the original trust was established. In all other respects it is worded identically to the deed for the original trust.

The two trusts are not the same for these reasons:

- the new trust is a potential beneficiary of the original trust (but the new trust is not, and cannot be, a beneficiary of itself)
- the original trust is a beneficiary of the new trust (but the original trust is not, and cannot be, a beneficiary of itself)
- persons who have donated more than $10,000 to the named charity between the establishment of the original and new trusts are beneficiaries of the original trust (but not of the new trust)
- the trustee and settlor of the original trust are excluded from benefiting under the original trust (but not the new trust), and
- the trustee and settlor of the new trust are excluded from benefiting under the new trust (but not the original trust).

Cross-benefits

The two trusts could be made the same in this regard if, for example, the new trust deed was drafted so that the new trust disclaimed any potential benefit under the original trust and the original trust was excluded from benefiting under the new trust. In this way the cross-benefits between the two trusts have been cancelled.

However, the trustee of the original trust may have been relying on the fact that the new trust was a potential beneficiary of the original trust as the source of its power to transfer the asset or assets to the new trust.

If the trustee has the power to amend the deed, then it may amend it to give itself the power to transfer the asset to the new trust. But this may raise the possibility of the general anti-avoidance power in Part IVA of the ITAA 1936 being applied if it is found that the amendment was made for the dominant purpose of providing a tax benefit.

Beneficiary inclusions

Those who had made relevant donations to the named charity between the establishment dates of the two trusts would have to be included as beneficiaries of the new trust.

Beneficiary exclusions

Steps would also need to be taken to ensure the same persons were excluded from benefiting. The trust deed for the original trust could be amended by excluding the trustee and the settlor of the new trust from benefiting under the original trust. In that way they are now excluded from benefiting under both trusts. Likewise, the deed for the new trust can be drafted so as to exclude the trustee and settlor of the original trust from benefiting under the new trust.

However, these amendments again raise the issue of Part IVA.

Alternatively, the new deed may be drafted so as to exclude the trustee and settlor of the original trust from benefiting under the new trust (so the original trust is excluded from benefiting under both trusts).

And the new deed may be redrafted so any reference to the new trustee and settlor benefiting under the new trust is deleted (so in theory the new trustee and settlor are *not* excluded from benefiting under either trust).

But practitioners may be reluctant to leave open the possibility of the trustee and settlor of the new trust benefiting under the new trust. This is because it could raise the prospect of the trust being a revocable trust under section 102 of the ITAA 1936. A revocable trust has adverse tax consequences for the trustee (as they would be taxed on some or all of the trust's income at penalty rates) which is why most discretionary trust deeds specifically exclude the trustee and settlor from benefiting.