

10 December 2008

Our Ref: D FESTA:
Please reply to: BRISBANE

The General Manager
Business Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600
BY EMAIL: cgt_trust_cloning@treasury.gov.au

Dear Sir/Madam

**ABOLISHING THE TRUST CLONING EXCEPTION
TREASURY DISCUSSION PAPER
ASSISTANT TREASURER'S PRESS RELEASE 31 OCTOBER 2008 NUMBER 092/08**

In the press release outlined above, the Assistant Treasurer proposed to repeal paragraphs 104-55(5)(b) and 104-60(5)(b) of the *Income Tax Assessment Act 1997*. The exception contained in these provisions has been used for legitimate estate planning and restructuring purposes within the purpose of the legislation. In this letter we set out our submission in relation to these proposals.

A brief background:

1. Until the announcement (operative from 1 November 2008), it had been possible to "split" one discretionary trust into two or more identical discretionary trusts, without activating a CGT Event (liability).
2. The ability to do this was supported by paragraph 104-55(5)(b) and 104-60(5)(b) of the ITAA 1997, which are the replacement provisions for subparagraph 160M(3)(a)(ii) of the ITAA 1936.
3. The relevant history of the legislation is:
 - 3.1 The capital gains tax provisions were introduced by the *Income Tax Assessment Amendment (Capital Gains) Act 1986* effective from 20 September 1985. Those provisions were expressed to apply to a change in the ownership of an asset;
 - 3.2 Sub-Section 160M(1A) was introduced by the *Taxation Laws Amendment Act 1990* to clarify that a change in ownership of the asset is only considered to occur where there is a change in the beneficial ownership of the asset. This provision has the effect that a mere change of trustee does not cause a change in ownership and is currently reflected in CGT Event A1;



- 3.3 Until 12 January 1994, it was arguably possible to subject an asset owned by a person to the trusts of a discretionary trust of which that person was the trustee. The reason for this is that, in a discretionary trust, no beneficiary has a right to any assets of the trust fund, with the result that the mere subjecting of an asset to a discretionary trust of which the owner is the sole trustee, did not cause a change in beneficial ownership.
- 3.4 On 12 January 1994, the then Treasurer announced an intended change to the provisions, to operate from the date of the announcement, to cause the creation of a trust per se over an asset (as described in the previous sub-paragraph) to be a CGT disposal but with some exceptions.
- 3.5 In implementation of this announcement, *Taxation Laws Amendment Act (No 2) 1994* removed the previous paragraph 160M(3)(a) and replaced it with a new paragraph of which subparagraph (ii) included what has been referred to as the trust cloning exception. The purpose of the exception in subparagraph (ii), as explained in paragraph 6.14 of the Explanatory Memorandum, was to provide that a disposal would not be taken to occur for an asset, although vested upon or transferred to another trust, where it is held under the same trust arrangements;
- 3.6 The essence of that exception was that if the trust being created over the asset is identical to an existing trust over the asset, then a CGT disposal would not occur.
- 3.7 *Obviously, this is because there is no real change in the beneficial ownership of the asset or of a beneficial interest in the asset.*
- 3.8 The CGT provisions were rewritten into the *Income Tax Assessment Act 1997* in which the exception referred to in subparagraph (ii) was incorporated as an exception to CGT Events E1 and E2 in paragraphs 104-55(5)(b) and 104-60(5)(b).
4. The effect of the exception is similar to demerger relief available to companies:
 - 4.1 Demerger relief allows an asset of a company group held in a subsidiary to be split off out of the company group to the ultimate owners (shareholders in the head entity) with those owners having the same rights in the subsidiary with the same kind of interest (company shares or trust interest), the same proportion of interests in the subsidiary and the same proportionate market value of ownership interests;
 - 4.2 Similarly, the trust exception allowed assets of a trust to be split off into a separate trust to be held under the same trust arrangements for the beneficiaries (ultimate owners) of the original trust having the same rights.
5. The reasons why a person would want to split a trust into two or more trusts (identical) were to attain asset protection or as a part of succession planning (principally, the latter).
6. An example of the use of splitting trusts (in more recent times called cloning trusts) for asset protection purposes is where the trust contains assets which might be subject to risk, eg, business assets, as well as assets which will not ordinarily be subject to risk, eg, investment assets. Trust splitting can be used to set up a new, identical trust

with the investment asset then transferred to it thus protecting it from the risks encountered in conducting a business.

7. In terms of succession planning:

- 7.1 A person cannot give away in his Will assets owned in a trust, even where the trust is controlled by that person. That is for the simple reason that the person does not own the asset.
- 7.2 The traditional method of dealing with trust assets, upon the death of the controller, was to leave a Letter of Wishes containing "riding instructions" as to the future conduct of the trust, and placing advisors, eg, the controller's accountant and solicitor, in full or partial control of the trust – in the expectation that the client's wishes would be carried out.
- 7.3 This approach was intended to prevent the majority of children attaining control of the trust, and "ganging up" against the minority of the children. *It did not always work.*
- 7.4 As you know, the person who controls a discretionary trust determines who gets the benefit of the trust assets.
- 7.5 Trust splitting or trust cloning has become a useful way to prevent a majority of beneficiaries "ganging up" against a minority: the trust is split into such number of trusts as equals the number of children and either particular assets are moved among the trusts or all of the assets are split evenly (or in other proportions desired by the controller) among the trusts but in both cases subject to the same trust arrangements – thus preventing some children causing others to miss out.

8. Recent developments:

- 8.1 The ATO, initially, appeared comfortable with the operation of the exception.
- 8.2 The ATO then started making announcements about some of the difficulties that might emerge in demonstrating that the two trusts were identical.
- 8.3 It has also become the practice for advisors to seek private rulings as to the identity of the trusts. This seems to have caused an increased workload for the ATO, with extended delays in provision of the rulings.
- 8.4 Earlier this year, in Adelaide, at the National Conference of the Taxation Institute of Australia, the Second Commissioner, Mr Bruce Quigley, stated that:
 - 8.4.1 The intended effect of the provisions was to simply allow a change of trustee without effecting a CGT Event.
 - 8.4.2 Nonetheless, the ATO accepted that the wording was wider than that.
- 8.5 Mr Quigley was wrong when he said that the intention of the provisions was to simply allow a change of trustees without a CGT Event occurring: that provision already existed (Subsection 160M(1A)), and, further, the purpose of the provisions was to recognise the continuance of the law as it previously was, namely, that the creation of a trust over an asset, or the vesting of an asset into

a trust, will not be a CGT Event (previously a CGT disposal) where there is no change in beneficial ownership, but with some limitations. A change of trustee is only one example of an event which does not lead to a change in beneficial ownership.

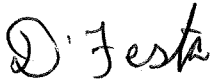
- 8.6 Later, as noted above, on 31 October 2008, the Assistant Treasurer, Mr Bowen, announced that, because of difficulties with the provision *and to bring certainty to taxpayers*, the provision would be deleted!
9. *This really is a "cop out" by the ATO, based on a misunderstanding of the history and purpose of the provisions by a "young ATO", and because of ATO difficulties.*
 10. *Normally, when there is a change in tax legislation, it is to address a mischief: either a mischief which is detrimental to the ATO/Government or a mischief which is detrimental to taxpayers.*
 11. *In this case, there is no mischief to address: only a difficulty in application of the provision by the ATO (administrative difficulty, at worst) and, as noted, a failure of the ATO to understand the history and purpose of the provisions.*
 12. All discretionary trusts must terminate within 80 years of commencement. At that time, the trust must be wound up, which will almost always result in the sale of assets; or, alternatively, it will result in the transfer of assets to beneficiaries.
 13. In either case, CGT Events will occur and CGT liabilities will arise. *This will be the case whether the assets have remained in one trust or reside in a number of identical trusts.*
 14. Just as transfers of assets owned by individuals, upon the death of those individuals, does not amount to a CGT Event, and therefore, to a CGT liability, the death of a controller of a trust does not give rise to a CGT Event or to a CGT liability.
 15. However, when the beneficiary of a deceased sells the asset, CGT liability will arise on any gain in the value of the deceased's assets up to the point of sale. Correspondingly, upon the wind-up of the trust, a CGT Event will occur and a CGT liability will arise.
 16. Further, on death of an individual owner, a pre-CGT asset becomes a post-CGT asset in the hands of the beneficiary. Similarly, a pre-CGT asset in a trust, when passed to a beneficiary, becomes a post-CGT asset in the hands of a beneficiary. More to the point, as the years progress, there are fewer pre-CGT assets to be considered.
 17. *Put simply, there is no mischief in these processes.*
 18. As noted, the use of trust splitting or trust cloning is primarily for succession planning, to bring more certainty to family members in the administration of the trust following the death of the family patriarch or matriarch. In the absence of the ability to split or clone trusts, the trust would still carry on, under a mixture of a Letter of Wishes and with partial or full control by parties external to the family (eg, advisors), but with less certainty for the family. *There is nothing in the traditional method or in the splitting of trusts, in the context of succession planning or asset protection, which involves tax avoidance.*
 19. If the ATO's concern is its own administrative workload, perhaps it could take the position that it will not provide private rulings in respect of factual circumstances

comprising the identity of trusts – albeit that such an approach may be at odds with the increasing trend of the ATO to expand the areas in which it will provide private rulings.

20. *However, restricting its activities in that way is far better than removing a genuine opportunity for succession planning for taxpayers, where no tax avoidance mischief is involved.*
21. Alternatively, if the difficulty identified by the ATO with the existing provisions is with doubts in the requirements of the exception, the true answer is to introduce a provision that is simpler in its operation. We suggest that one option is a provision that provides for the exception where the beneficiaries of each trust are the same and, to borrow from the demerger provisions, have equivalent rights namely the same type of interest (discretionary, unit or fixed interest), same percentage entitlement to distributions of income and capital and voting power (if relevant) and same proportionate market value.

We would be pleased if you would give this submission full consideration.

Yours faithfully



Domenic Festa

Cleary Hoare Solicitors

This office will close from end of business on 19 December 2008 and re-open on 5 January 2009.

★ The Principals and Staff of Cleary Hoare wish you a Merry Christmas. 🛎